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TAX AND SUPERANNUATION LAWS AMENDMENT (2015 MEASURES NO. #) BILL 2015: PROVIDING 'LOOK-THROUGH' CGT TREATMENT TO EARNOUT ARRANGEMENTS

EXPLANATORY MATERIALS

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Chapter 1
Providing 'look-through' CGT treatment to earnout arrangements

Outline of chapter

1.1 Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to change the capital gains tax (CGT) treatment of the sale and purchases of businesses involving certain earnout rights – rights to future financial benefits linked to the performance of an asset or assets after sale.

1.2 As a result of these amendments, capital gains and losses arising in respect of eligible earnout rights will be disregarded. Instead, financial benefits received under the earnout rights will affect the capital proceeds and cost base of the underlying asset or assets to which the earnout arrangement relates.

Context of amendments

Background

1.3 On 12 May 2010, the former Government announced that the tax law would be amended to provide look-through CGT treatment for qualifying earnout arrangements entered into as part of the sale of business assets.

1.4 On 14 December 2013, the then Assistant Treasurer, Senator the Hon Arthur Sinodinos AO, announced that following consultation on a number of the 92 announced but unenacted measures of the previous Government, the Government would proceed with several of the measures including the proposed amendments to provide look-through CGT treatment to qualifying earnout arrangements.

Earnout arrangements

1.5 An earnout arrangement is an arrangement whereby as part of the sale of a business or the assets of a business, the buyer and seller agree that subsequent financial benefits may be provided, based on the future

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performance of the business or the related business in which the assets are used.

1.6 In a standard earnout arrangement, the buyer agrees to pay the seller additional amounts if certain performance thresholds are passed within a particular time. In a reverse earnout arrangement, the seller agrees to repay amounts to the buyer if certain performance thresholds are not passed within a particular time. Some earnout arrangements combine the features of both a standard earnout and a reverse earnout as both the buyer and seller may be obligated to provide financial benefits dependent on performance.

1.7 Earnout arrangements are commonly used in the sale of businesses where there is difficulty agreeing about the value of the business due to difficulty determining its future economic performance. In this situation, to allow the parties to agree on a price, the earnout arrangement ties additional financial benefits (or, for a reverse earnout, refunds of prior financial benefits) to the future performance of the business.

1.8 For example, two parties are negotiating the sale of the business where a significant part of the value of the business is tied to its customer base – that is its goodwill. There is considerable uncertainty about how the sale and other factors may impact upon this goodwill. The parties could agree to a price based on the best available estimate of the businesses' value, but there would be a significant chance that the estimate will be incorrect in a material way. Alternatively, the parties could agree to an earnout arrangement under which part of the consideration for the sale was linked to the future economic performance of the business. This avoids the need to rely on an estimate by linking financial benefits to the ascertainment of future events.

CGT and earnouts arrangements

1.9 For the purposes of CGT, a business consists of a number of CGT assets (including the business's goodwill, debts and contractual rights as well as the physical assets of the business).

1.10 The sale of a business will generally either involve the disposal of some or all of these assets, or, if the business is held through a company or trust, the sale of an interest or interests in the relevant entity, all of which will generally give rise to capital gains or losses to which CGT applies.

1.11 The Commissioner of Taxation (Commissioner) provided public advice setting out the treatment of earnout rights – rights to future

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financial benefits under earnout arrangements – in a draft public ruling in 2007 (Draft Taxation Ruling TR2007/D10).

1.12 Under the view taken in this ruling, where the sale of a business involves an earnout arrangement, the earnout right or rights that are created will be separate CGT assets.

1.13 Where an earnout right is provided by the buyer to the seller in relation to the disposal of a business (a standard earnout arrangement) the earnout right will be property the seller received (or is entitled to receive) in relation to the disposal and forms part of the capital proceeds of the disposal. Where a right is provided from the seller to the buyer (a reverse earnout arrangement), the right is an additional asset being provided along with the other business assets and the capital proceeds must be apportioned between the creation of the right and other related CGT events, such as the sale of the assets.

1.14 In all cases the tax consequences for the parties to the disposal are tied to an estimate of the current value of the earnout right at the time the CGT event occurs. As the rationale for the creation of the earnout right is the difficulty in estimating the value of the business, there is a strong chance any estimate of the value of the earnout right will differ from the financial benefits that are in fact provided or received. If the estimated amount of these future financial benefits differs from the financial benefits actually provided or received this will not result in any change to the capital proceeds and cost base of the business assets.

1.15 Subsequent financial benefits provided under the right can result in a capital gain or loss for the holder of the right as a result of CGT event C2 occurring (see section 104-25 of the ITAA 1997). However, there will be no CGT consequences for the entity obliged to provide financial benefits under the right, with the result that the costs of providing these financial benefits are generally not recognised under the capital gains tax system.

1.16 The CGT concessions that can apply to the sale of business assets will not be relevant to either the amounts paid for the creation of the earnout right or subsequent financial benefits provided under the right. While the right may be linked to a business, it is a separate CGT asset with different characteristics and, unlike the business assets, will not satisfy the tests for the relevant concessions (including the active asset test – see section 152-35 of the ITAA 1997).

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Summary of new law

1.17 Schedule # provides that taxpayers may disregard capital gains or losses that arise in relation to a qualifying right to financial benefits– a 'look-through' earnout right.

1.18 Instead, taxpayers must include financial benefits provided or received under or in relation to such rights in determining the capital proceeds of the disposal of the underlying asset (for the seller) or the cost base and reduced cost base of the underlying asset for the buyer.

1.19 Schedule # also amends the rules around amendments to assessments, interest charges, recognition of capital losses and access to CGT (and other) concessions to ensure this new treatment provides taxpayers with outcomes broadly consistent with those that would have arisen had the value of all of the financial benefits under the earnout right been included in the capital proceeds from the disposal of the underlying asset for the seller and the cost base or reduced cost base of the underlying asset for the buyer.

Comparison of key features of new law and current law

New law	*Current law*
Capital gains and losses in respect of a look-through earnout right are disregarded.	No special rules apply to capital gains or losses in respect of rights to future income under earnout arrangements.
Financial benefits under or in respect of a 'look-through' earnout right are included when determining the capital proceeds or cost base of the underlying business asset to which the arrangement relates.	No special rules apply to financial benefits provided under or in respect of earnout rights.
A taxpayer's assessment for a tax related liability that can be affected by financial benefits provided or received under a 'look-through' earnout right may be amended for up to four years after the earnout arrangement expires.	No special rules apply to financial benefits provided under or in respect of earnout rights.
Capital losses arising from a CGT event related to an earnout right may not be taken into account in determining tax liabilities until such time as they cannot be reduced by future financial benefits received	No special rules apply to losses arising under or in respect of earnout rights.

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New law	Current law
under a relevant look-through earnout right.	

Detailed explanation of new law

1.20 Schedule # makes a number of modifications to the operation of the capital gains tax provision in respect of CGT events that happen in under or in relation to certain earnout rights – referred to as a ***look-through earnout right***.

Look-through earnout rights

1.21 A ***look-through earnout right*** is a right to future financial benefits, and unascertainable at the time the right is created. The right must be created under an arrangement involving the disposal of a CGT asset that is an active asset of the seller, and the financial benefits under the right must be contingent on and reasonably related to the future economic performance of the asset (or a related business). ***[Schedule #, item 4, sections 118-560 and 118-565 of the ITAA 1997]***

1.22 This definition reflects a variety of policy considerations around the scope of this measure.

1.23 Broadly, these amendments will allow for the deferral of the payments of income tax in relation to part of the consideration for the purchase of a business or its assets. However, this deferral will be available only in a particular set of circumstances – it is not intended to allow taxpayers to generally delay the payment of income tax.

1.24 Instead, the proposed changes are intended to ensure that the CGT law does not present a barrier to a specific type of transaction – the sale of a business where disagreement about the value of the business going forward is resolved by at least one of the parties agreeing to provided future financial benefits linked to the performance of the business. The requirements around look-through earnout rights limit the availability of the deferral to this specific circumstance.

Disposal of the business or its assets

1.25 To this end, to be a look-through earnout right, a right must be created as part of an arrangement for the disposal of the business or its assets – that is, the disposal must cause CGT event A1 to happen. ***[Schedule #, item 4, paragraphs 118-565(1)(a) to (c) of the ITAA 1997]***

1.26 Under the CGT law, where a disposal occurs, CGT event A1 will happen, either on its own or, in some cases, in addition to one or more other CGT events. The requirement around disposal is intended to limit the benefit of this concession to arrangements for the disposal of a business. The concession for look-through earnout rights is intended to address the difficulties in determining the value of a business (or certain assets of the business). It is not intended to provide tax benefits to temporary transfers (such as leases), ongoing business relationships or complex financing arrangements.

1.27 Similarly, what is disposed of must be an active asset of the business before it is sold. ***[Schedule #, item 4, paragraph 118-565(1)(d) of the ITAA 1997]***

1.28 As discussed this measure applies to the sale of a business or the assets of a business. The concept is already found in the CGT law as 'active asset'.

1.29 Active asset is defined in section 152-40 of the ITAA 1997. Broadly, and subject to certain exclusions, an active asset is an asset of the taxpayer that is used in the business of the taxpayer or a connected or affiliated entity. A membership interests in an Australian resident company or trust will also be an active asset if at least 80 per cent of the value of the assets of the company or trust are active assets (rather than passive investment).

1.30 It is important to note that applying the special rules around membership interest may involve a number of steps – for example, if the sole asset of Company A is a share in Company B, which itself only holds a share in Company C, the character of interests in both A and B will depend on the character of the assets of C.

1.31 Assets that are not active assets are not sufficiently linked to the conduct of a business to fall within the intended scope of the concession for earnouts.

1.32 However, the general definition of active asset poses certain difficulties in the context of determining if the definition is satisfied by a share in a company or an interest in a trust. Determining if these assets are active assets requires valuing the assets of the underlying entity. As one of the problems these amendments are intended to address is that these rights to future income are difficult to value at the time of sale, requiring a valuation to access the concession would run counter to this purpose.

1.33 To address this, the amendments provide that an eligible share or an interest in a trust is treated as an active asset in the hands of an entity

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for the purpose determining if look-through earnout right exists. To be an eligible share or interest:

- the entity holding the share or interest must either:
  - if they are an individual, be a CGT concession stakeholder in relation to the company or trust; or
  - if they are not an individual, own a sufficient share of the business that they would be a CGT concession stakeholder were they an individual,
- the trust or company must carry on a business and have carried on a business or businesses for at least one prior income year; and
- for the immediately preceding income year, at least 80 per cent of the income of the trust or company must have come from the carrying on a business or businesses and not been derived as an annuity, interest, rent, royalties or foreign exchange gains, or derived from or in relation to financial instruments.

[Schedule #, item 4, section 118-570 of the ITAA 1997]

1.34 This alternative test allows taxpayers to avoid the need to value the assets of the trust or company. Instead, they need only look at how the trust or company has earned its income over the past income year. This achieves broadly the same policy goal – of ensuring the concession is available only in relation to the sale of a business – while relieving taxpayers of the compliance costs associated with obtaining a reliable valuation in respect of contingent future financial benefits.

1.35 Consistent with the rules for active assets generally, this alternative test for active assets is not restricted to assets held by the taxpayer. Where the character of a share or interest held by the taxpayer depends on the character of the shares or rights held by other entities, this alternative test can also apply when determining the characters of the shares or interests held by that other entity.

Example 1.1

Jonathan is approached by XYZ Ltd which wishes to purchase Gardening Ltd and Building Ltd. Both companies are both wholly-owned by Holding Ltd, a company wholly-owned and controlled by Jonathan.

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Following negotiations Jonathan and XYZ Ltd agree that Jonathan will sell his shares in Holding Ltd to XYZ Ltd for $1 million, plus the right to a further payment of up to $500,000 based on the performance of Gardening Ltd and Building Ltd against certain profit targets over the next two years.

For this right to be a look-through earnout right, amongst other things, Jonathan's shares in Holding Ltd must be an active asset.

For shares in a company to be an active asset of a taxpayer for these purposes, either:

- at least 80 per cent of the market value of the assets of the company, including any cash or financial instruments held by the company, must be active assets; or

- the company, in which the taxpayer had a small business participation percentage of at least 20 per cent, had been carrying on business for at least one whole income year and during that time at least 80 per cent of the income of the company derived from carrying on that business and not from passive investment.

As Holding Ltd is not carrying on a business its shares cannot qualify to be treated as active assets under the extra method provided under these amendments. Therefore, Jonathan's shares will only be an active asset if Holding Ltd's shares in Building Ltd and Gardening Ltd are active assets.

Gardening Ltd holds no assets that are not active assets. As a result, Holding Ltd's shares in Gardening Ltd are also active assets.

Building Ltd holds financial instruments that cannot be active assets and the value of some of its active assets, particularly its goodwill is difficult to determine. However, Building Ltd has been in existence for 5 income years and in the past income year 99 per cent of its income related to its building services business, with less than 1 per cent being derived from financial instruments.

As Holding Ltd has a small business participation percentage of 100 per cent in Building Ltd, its shares in Building Ltd can be treated as an active asset.

As a result, all of Holding Ltd assets can be treated as active assets and so Jonathan's shares in Holding Ltd can also be treated as active assets for these purposes, permitting Jonathan to treat the right to future payments as a look-through earnout right provided the other requirements are satisfied.

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Contingent on the future economic performance of the asset

1.36 For a right to be a look-through earnout right, future financial benefits provided under the right must be linked to the future economic performance of the asset or a business in which the asset is used. ***[Schedule #, item 4, paragraphs 118-565(1)(f) and (g) of the ITAA 1997]***

1.37 The concession provided to look-through earnout rights is only intended to cover rights provided to resolve uncertainty about the value of the business that is being sold due to difficulties determining future economic performance, not to all deferred payment arrangements.

1.38 Economic performance is a flexible concept, broadly encompassing the success of the relevant economic activity. Whether a particular measure identifies economic performance will often depend on the context of the business or asset in question. Measures that can be appropriate include profit, turnover or even non-financial measures such as the number of clients retained or attracted.

1.39 However, any measure adopted must be actually be a reasonable measure of performance in the context of the business or asset in question. Hence, while some measures such a profit will usually be appropriate, it is always necessary to consider how the economic performance of the business can reasonably be measured. For example, a right to financial benefits linked to a financial index or benchmark rate will generally only be appropriate where this is a reasonable basis for determining the performance of the particular asset or business.

1.40 In considering this, it is important to distinguish between economic performance and the discovery of further information issues. Rights to financial benefits that are based on finding out more information about an existing asset are not contingent on economic performance – they do not relate to performance at all. For example, a right to future financial benefits in relation to a potential mineral resource based on the value of any ore reserves once identified is not contingent on economic performance – rather it is contingent on purely on obtaining further information about an existing asset. Such rights are not intended to benefit from the deferral provided for look-through earnout rights.

1.41 Further it is not enough for this right to be contingent on the future economic performance of the asset or the business in which it is used – it must provide for financial benefits the value of which reasonably relates to this performance.

1.42 This means that, for example, a right to future financial benefits provided as part of the sale of a business where the financial benefits are contingent on the business meeting certain profit targets would not qualify

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as a look-through earnout right if the value of the financial benefits to be provided was out of all proportion to the benefit received from this profitability. This requirement does not entail a precise or mathematical link between performance and payment – a lump sum payment may well be as appropriate as a percentage of profits. However, value of the contingent financial benefits provided under the right not be disproportionate to the benefits that could have been reasonably expected to result from the performance to which they are linked.

1.43 To the extent financial benefits provided under a right may not reflect economic performance, they are for some other purpose than resolving this uncertainty and are outside the intended scope of this concession.

Example 1.2

> Cake Co has acquired a number of businesses including Cupcake Ltd and Muffin Ltd as part of a plan to expand from the wholesale to retail baking sector.
>
> As part of the purchase of Cupcake Ltd and Muffin Ltd, Cake Co agreed to provide a right to future payments to the former owners of these businesses if certain conditions are met.
>
> For Cupcake Ltd, Cake Co has agreed to provide payments if the number of customers making purchases from Cupcake Ltd exceeds a specified number. These payments may be contingent on economic performance – the number of purchases can be a reasonable measure of economic performance of a business, especially a retail business.
>
> For Muffin Ltd, Cake Co has agreed to provide a further payment based on the outcome of certain litigation being undertaken by Muffin Ltd. This payment is not contingent on economic performance. It does not relate to the performance of Muffin Ltd or any of its assets but to clarification by a court of legal obligations – while this may affect the value of Muffin Ltd or its assets it has nothing to do with their economic performance.

1.44 For a right to be a look-through earnout right, the financial benefits provided must also be not able to be reasonably ascertained at the time the right is created. ***[Schedule #, item 4, paragraph 118-565(1)(a) of the ITAA 1997]***

1.45 In most cases, the fact that financial benefits are contingent will mean that they are also reasonably unascertainable. However, in some cases a benefit may be contingent on future events where there is little or no doubt that these events will transpire. In this case, the benefit can reasonable be ascertained and the right cannot be a look-through earnout right.

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Four year payment limitation

1.46 For a right to be a look-through earnout right, the right must not require financial benefits to be provided more than four years after CGT event A1 occurs in relation to the disposal of the relevant active asset. ***[Schedule #, item 4, paragraph 118-565(1)(e) of the ITAA 1997]***

1.47 The purpose of this requirement is twofold.

1.48 First, this requirement ensures concessions for look-through earnout rights are not available to long-term profit sharing arrangements. Such arrangements are in substance the transfer of equity arrangement and should be treated similarly to other such transfers.

1.49 Secondly, the requirement places a reasonable limit on the period of deferral to avoid providing excessive and distorting benefit to look-through earnout rights. The intention of the measure is to address the potential difficulties created by valuing earnout rights for tax purposes, not to create tax incentives for the use of earnout rights.

1.50 This requirement is not breached simply because one party or another may be late in providing a financial benefits under the look-through right.

1.51 However, it will be breached if the agreement includes an option for the parties to extend the period over which financial benefits are provided or to enter into a new agreement providing for the continuation of substantially similar financial benefit in relation to the asset.

1.52 Further, if the parties vary the right to extend the period over which financial benefits are provided beyond four years or enter into a new agreement to create an equivalent right to further future financial benefits after this time then the right will be taken to have never been a look-through earnout right. ***[Schedule #, item 4, section 118-565(2) of the ITAA 1997]***

Example 1.3

> David has purchased Wine Ltd from Adam. Under the arrangement, David undertook to make a number of further payments to Adam based on the profits earned by Wine Ltd, the last of which was due one month before the 4 year anniversary of the sale. The right to these further payments met the requirement to be a look-through earnout right.
>
> The conditions for this final payment to be made are satisfied, but, due to a series of administrative errors, David is 6 months late in providing the payment.

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As a result, the final payment under the look-through earnout right occurs more than 4 years after the sale. However, this does not affect the character of the right as a look-through earnout right – the late payment by David does not alter the fact that the right still only provided for financial benefits over four years

Example 1.4

Judy has sold her business, Pharma Co, to Vanessa.

Under the arrangement, Vanessa agrees to provide Judy with 5 per cent of the annual profit of Pharma Co over the next three years if the profits for the year exceed a fixed threshold. This right qualifies as a look-through earnout right.

In the third year of the arrangement, Judy and Vanessa agree that the payments will continue for a further 5 years in exchange for Judy making a lump sum payment to Vanessa.

As a result of this extension, Judy is now entitled to receive future financial benefits that are contingent on economic performance more than 4 years after the time she disposed of the business.

Due to this, the right is now not a look-through earnout right and is taken to have never been a look-through earnout right. Judy and Vanessa may now need to request that the Commissioner make appropriate changes to their income tax assessments.

Arm's length

1.53 Finally, all look-through earnout rights must be created as part of arrangements entered into on an arm's-length basis. ***[Schedule #, item 4, paragraph 118-565(1)(h) of the ITAA 1997]***

1.54 The concessions provided to look-through earnout rights are only intended to be available for commercial transactions. Allowing the concessions to be available for non-commercial arrangements is inappropriate and would create scope for abuse.

Rights to receive financial benefits for ending a look-through earnout right

1.55 A right will also be a look-through earnout right if it is a right to receive a certain financial benefits provided for ending a right that is a look through earnout right under the general rules. ***[Schedule #, item 4, subsection 118-565(3) of the ITAA 1997]***

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1.56 A right to receive payment for ending an earnout right generally includes a right to receive a payment for transferring the entitlement to payment to another, as the original entitlement has been lost.

1.57 Payments to end a look-through earnout rights are in effect a replacement for the payments that would have been made under the right. By providing the same tax treatment even where the financial benefit may be provided by a third party, these amendments avoid inconsistent tax treatment and unnecessary complexity.

Consequences of a right being a look-through earnout right

1.58 Broadly, if a right is a look-through earnout right, two consequences arise:

- the value of the right is disregarded for the purposes of CGT; and
- the value of any financial benefits made or received under the right is included in either the capital proceeds arising from the disposal (for the seller) or the cost base of the acquisition (for the buyer).

Disregarding the right

1.59 Generally, when a taxpayer creates or disposes of a CGT asset, the taxpayer must take into account any money and property received when determining the capital proceeds arising from the CGT event or events. Similarly, when acquiring a CGT asset, a taxpayer takes into account the full value of any money and other property provided to acquire the asset in determining the cost base of the asset.

1.60 However, as was identified previously, in the case of earnout rights this can pose difficulties. The purpose of providing the right to future financial benefits under such arrangement is often to resolve difficulty in agreeing a valuation. In this context, requiring a valuation goes against the rationale for the concession.

1.61 To address this, any capital gain or loss arising in respect of the creation or cessation of a look-through earnout right will be disregarded. ***[Schedule #, item 4, section 118-575 of the ITAA 1997]***

1.62 Similarly, the value of a look-through earnout right will not be taken into account in determining the capital proceeds of the disposal of the active asset for the seller nor the cost base and reduced cost base of the asset acquired by the buyer. ***[Schedule #, items 1 and 3, paragraphs 112-36(1)(a) and 116-120(1)(a) of the ITAA 1997]***

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Adjusting the capital proceeds and the cost base for subsequent financial benefits

1.63 In the place of taxing the value of the look-through earnout rights, Schedule # amends the income tax law to include the value of any financial benefits subsequently provided or received under or in relation to such a right in the capital proceeds of the disposal of the related active asset for the seller, or the cost base and reduced cost base of the asset for the buyer. ***[Schedule #, items 1 and 3, paragraphs 112-36(1)(b) and (c) and 116-120(1)(b) and (c) of the ITAA 1997]***

1.64 This ensures that the value of the consideration received under look-through earnout rights is appropriately recognised in the tax system, without requiring the right itself to be valued.

Example 1.5

Anna sells her business, ABC Co, to Purple Ltd in March 2016.

Under the sale arrangement, Anna receives an upfront payment of $1 million at the time of sale and a right to two future payments in March 2017 and March 2018, each of $100,000, provided the turnover of ABC Co exceeds an agreed threshold during 2016 and 2017 respectively. This right is a look-through earnout right.

At this time Anna's capital proceeds for the sale of the business are $1 million – the total of the upfront payment she has received. Anna has also received the right to future payments which she would generally need to include in the capital proceeds, but as this is a look-through earnout right, the value of right is disregarded when working out the capital proceeds.

As Anna has a cost base of for ABC Co of $600,000, at this time Anna has a capital gain of $400,000 (capital proceeds of $1 million less the cost base of $600,000) as a result of the sale.

ABC Co's turnover exceeds the agreed threshold in 2016 and so Purple Ltd pays Anna a further $100,000.

As a result of this payment, the capital proceeds for the sale of ABC Co are now $1.1 million – made up of the 1 million initial payment payment and the $100,000 payment she received in March 2017. She has now made a capital gain of $500,000 (capital proceeds of $1.1 million less the cost base of $600,000) as a result of the sale.

Finally, in July 2017, Purple Ltd decides it would prefer to end the arrangement immediately. It offers to pay Anna $50,000 if she will agree to forgo her right to further payments under the look-through earnout right and Anna agrees to this offer.

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This financial benefit provided to terminate a look-through earnout right is treated in the same way as a financial benefits provided under the right.

As a result, Anna's total capital proceeds for the sale are now $1.15 million, made up of the $1 million initial payment, the subsequent $100,000 payment under the earnout right and the $50,000 payment to end the earnout right.

Anna's final capital gain from the sale is $550,000 (capital proceeds of $1.15 million less the cost base of $600,000).

Choices and timing

1.65 However, this approach does result in the amount of a capital gain or loss changing as a result of financial benefits provided or received subsequent income years. A number of special rules are required to ensure that this does not disadvantage taxpayers or impose unnecessary compliance and administrative costs.

1.66 The first difficulty that could arise relates to the gap between the CGT event and the financial benefits provided under an earnout right.

1.67 As the financial benefits may be provided up to four years after the CGT event, for some taxpayers, the period of review for the income year in which the CGT event occurred may have passed before the taxpayer has provided or received the financial benefits requiring the amendment.

1.68 To address this, these amendments extend the period of review for all of a taxpayer's tax-related liabilities that can be affected by the character of the look-through earnout right. The amendments also extend the period of review in respect of tax-related liabilities that can be affected by the character of rights that are treated as never having been an earnout right (see paragraph #.52). ***[Schedule #, items 1 and 3, subsections 112-36(3) and 116-120(3) of the ITAA 1997]***

1.69 For these tax-related liabilities, the period of review is the later of the period of review that would normally apply and four years after the final date when financial benefits could be provided under the look-through earnout right.

1.70 This extension applies to all tax-related liabilities that can be affected by the change to a capital gain or loss as a result of financial benefits provided under a look-through earnout right. This includes liabilities in subsequent years and tax-related liabilities for taxes other than income tax. For example, the small business CGT retirement concessions provide, broadly, that certain contributions to superannuation

linked to capital gains arising from the sale of business asset are not counted towards non-concessional superannuation contribution caps. If the amount of the relevant gain for a taxpayer changes as a result of the financial benefits provided under an earnout right, the extended amendment period would apply to the assessment of the taxpayer's non-concessional contributions.

1.71 In certain limited cases, changing the capital proceeds or cost base of a CGT asset held by one taxpayer may impact upon the tax-related liabilities of another taxpayer. For example, certain small business CGT concessions provide benefits for CGT concession stakeholders in a company. This extension will also apply to the tax-related liabilities of these related entities if they can be affected by the character of a right as look-through earnout right.

1.72 The extension also applies to a taxpayer's right to object where they are dissatisfied with an assessment. Where the Commissioner amends a taxpayer's assessment because of a financial benefit provided or received under an earnout right or a right that is taken to never have been an earnout right, the taxpayer may object in the same way the taxpayer may object to any other amendments to an assessment. Where a taxpayer is dissatisfied with an assessment as the Commissioner has not made an amendment due to a financial benefit provided or received under an earnout right, these amendments will allow the taxpayer to object within 60 days of receiving notice of the Commissioner's decision not to amend the assessment. ***[Schedule #, items 1, 3 and 32, subsections 112-36(5) and 116-120(5) of the ITAA 1997 and paragraph 14ZW(1)(aaaa) of the Taxation Administration Act 1953]***

1.73 The second difficulty is that, under the general CGT law, a taxpayer is not able to change a choice that they have previously made.

1.74 In this situation, where the amount of a gain or loss may substantially vary from the amount of the gain or loss identified in the year in a way that is uncertain, it would not be reasonable to require taxpayers to adhere to their initial choice (indeed in some situation a taxpayer may not have been eligible to make the choice they now wish to make based on the gain or loss in that initial year).

1.75 These amendments will permit taxpayers to amend a choice made previously where the choice relates to a capital gain or loss that can be affected by financial benefits provided under a look-through earnout right. The decision to vary a choice must be made by the time the taxpayer is required to lodge a tax return for the period in which the financial benefits under the look-through earnout right is received. ***[Schedule #, items 1 and 3, subsections 112-36(2) and 116-120(2) of the ITAA 1997]***

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1.76 Thirdly, taxpayers must generally pay interest on the amount of any income tax due for an income year that is not paid by the due date for payment. Similarly, but in more limited circumstances, the Commissioner may pay taxpayers interest on overpayments of tax.

1.77 As financial benefits provided or received under look-through earnout rights modify the capital proceeds of a disposal and the cost base of the asset acquired in an earlier year, underpayments and overpayments will unavoidably arise in this year for affected taxpayers. The imposition of interest on these amounts would not be appropriate.

1.78 Instead, the Schedule will provide that:

- taxpayers will not be subject to interest on any shortfall that arises as a consequence of financial benefits provided or received under a look-through earnout right, as long as the taxpayer requests an amendment to their relevant income tax assessment within the period they must lodge their income return for the income year in which the financial benefit was provided or received; and
- the Commissioner will not be liable for interest on any overpayment of tax that arises as a result of financial benefits provided or received under a look-through earnout right.

[Schedule #, items 33 to 36, subsections 280-100(5), 280-102A(4) and 280-102B(4) in Schedule 1 to the Taxation Administration Act 1953 and subsection 9(1B) of the Taxation (Interest of Overpayments and Early Payments) Act 1983]

1.79 Effectively, neither taxpayers nor the Commissioner will need to pay interest solely because a financial benefit is provided or received under a look-through earnout right.

1.80 The final difficulty is that this measure may result in changes to the capital loss available to taxpayers back over four years. This means that in some cases where entities dispose of assets and receive a look-through earnout right, they will initially be in a capital loss position. However, they will have a strong expectation that this will change as a result of subsequent financial benefits they will receive under the right.

1.81 Under the normal rules governing the income tax treatment of capital losses, this notional loss could affect tax positions in each year until the year in which the earnout arrangement expires. This could potentially result in financial benefits that reduce this loss requiring amendments to assessments not just to the year in which the disposal occurred, but to every subsequent year in which part of the loss was applied. Over a four year amendment period, this could potentially involve 10 separate amendments (that is, assuming one financial benefit

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was received in each income year, one amendment would be made in the first year to the assessment of the original year, two in the second year to the assessments for both the original year and the first year and so forth, up to the fourth year where four amendments would be needed, resulting in a total of 10 amendments).

1.82 Further, in this situation the taxpayer would also receive an excessive tax benefit. By being able to make use of the 'loss' they have incurred on the disposal until subsequent financial benefits are received under the earnout right, they have been able to defer not just the payment of any tax on the eventual capital gain from the disposal, but also in respect of other capital gains arising in subsequent years.

1.83 To avoid these concerns, capital losses arising from disposals of assets to which look-through earnout rights relate will be temporarily disregarded until and to the extent that they become reasonably certain. ***[Schedule #, item 4, section 118-580 of the ITAA 1997]***

Example 1.6

In June 2016, Lucas sold his business, Software Enterprises Ltd (a small business entity with only active assets) to Buyer Co.

Lucas receives a fixed upfront payment of $750,000 and has a number of additional entitlements to future payments under several look-through earnout rights contingent on a variety of profit and performance targets being met by Software Enterprises. As he has a cost base of $800,000 for Software Enterprises, at this stage Lucas has made a capital loss of $50,000. However, as Lucas may potentially receive further payments of an amount greater than $50,000 under the look-through earnout rights, he must disregard this loss in both the current year and subsequent years.

In the 2016-17 financial year, Lucas receives further payments totalling $250,000 under the look-through earnout earnout rights. This payment is included in the capital proceeds of the sale of Software Enterprises, meaning that Lucas has now received a total of $1 million and has a capital gain of $200,000. This gain results in an increase in his income tax liability for that year.

At the same time as Lucas lodges his tax return for the 2016-17 year, he also requests an amendment to his assessment for the 2015-16 income year to include the additional capital gain resulting from the payment under the rights. As a result he would not be subject to shortfall interest charge on any amount of additional tax he must pay for the 2015-16 year as a result of this amendment – in effect he is in the same position as if the payment had been taxed in the income year in which it was received.

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In June 2020, Lucas receives a final payment of $100,000 under the look-through earnout rights. Consistent with the previous payments this amount is included in the capital proceeds of the sale and Lucas requests an amendment to his income tax assessment for 2015-16 to reflect the increased capital gain of $300,000.

As an individual who did not satisfy any of the conditions for a longer amendment period, Lucas's assessment for 2015-16 would normally only be able to be amended by the Commissioner for two years from the date of the original assessment. By June 2020, this period would have passed.

However, in this case, the Commissioner may still amend Lucas's assessment in respect of the payment as it is a financial benefit under a look-through earnout right that affects the amount of Lucas's income tax liabilities for the year in which the sale occurred and the amendment is sought within four years of the expiry of the right.

Access to CGT concessions

1.84 The changes to the treatment of look-through earnout rights are only intended to affect a taxpayer's entitlement to CGT concessions insofar as this may occur as a result of the value of the underlying disposal now including all of the amounts provided for and under the earnout right.

1.85 In general, this is achieved without the need for additional special rules. Taxpayers are entitled to remake choices relating to the disposal or the asset they received as a result of the disposal. As a result, taxpayers may reconsider any choices and their entitlement to concessions in light of subsequent payments ensure that the resulting gain, loss or cost base reflects any concessions that are available and only those concessions that are available.

1.86 Likewise, in some cases, a taxpayer may not initially be in a position to elect for a concession to apply to a CGT event. Alternatively, a taxpayer may be concerned that anticipated future financial benefits in respect of a look-through earnout right may mean that they cease to be eligible for a concession to apply after they have taken irrevocable actions based on this concession (such as making contributions to superannuation). In these cases, as the taxpayer can remake choices they can simply wait until it is clear whether or not they will be finally eligible for the concession before making any choice.

1.87 However, some of the CGT small business concessions require things to be done or decisions to be made within a fixed period of the time the relevant CGT event occurs. Specifically:

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- the CGT small business retirement exemption in Subdivision 152-D of the ITAA 1997 allows a taxpayer to disregard all or part of a capital gain, if, relevantly, the taxpayer contributes an equivalent amount to their superannuation, or if the taxpayer is a company or trust, the superannuation of the CGT concession stakeholder of the company or trust, either when the proceeds are received or at the time the choice is made for an individual, or seven days after these times for a trust or company;

- the CGT small business 15 year exemption in Subdivision 152-B of the ITAA 1997 permits a company or trust may disregard an amount in determining its taxable income if, amongst other things, the amount is paid to a CGT concessional stakeholder within two years after the relevant CGT event;

- additionally, section 292-100 of the ITAA 1997 provides, amongst other things, that if the taxpayer receives a payment from a trust or company of the sort described in the second dot point above within two years of the relevant CGT event and subsequently contributes this amount to superannuation, the amount of this contribution does not count towards the non-concessional contributions cap; and

- the CGT small business 'rollover' allows the taxpayer to disregard a capital gain, but may result in a capital gain arising for the taxpayer under certain other CGT events (CGT events J2, J4, J5 and J6) if the taxpayer does not acquire an appropriate asset or undertake suitable expenditure within a the replacement asset period, which ends two years after the last CGT event in the year in which the 'rollover' is accessed.

1.88 These concessions would be problematic in the context of look-through earnout rights as actions may need to occur before the final amount of the relevant capital gain or loss is known.

1.89 To address this, the period accessing these concessions is extended.

1.90 For the CGT small business retirement exemption, special rules already exist for instalment payments that allow the concession to apply where amounts are contributed as payments are received. However, there may be doubts about whether financial benefits under an earnout right are instalments. The amendments would specifically apply the same rules to financial benefits received under or in respect of earnout rights.

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[Schedule #, items 13 and 16, subsections 152-125(1)(b) and 292-100(4)(b) of the ITAA 1997]

1.91 For the CGT small business 15 year exemption, and the related concession under section 292-100 in relation to non-concessional contributions, the two year period is extended to last until two years after final potential financial benefit under the look-through earnout right is concluded. ***[Schedule #, items 14 and 15, subsections 152-305(1B) and 152-335(2A) of the ITAA 1997]***

1.92 Finally, for the CGT small business 'rollover', the replacement asset period would similarly be extended until two years after potential final financial benefit under the look-through earnout right is concluded. ***[Schedule #, items 6, 8 to 12 and 17, paragraph 104-185(1)(a), subsections 104-190(1A) to (3) and (5), paragraph 104-198(1)(a), subsections 104-198(2) and (4) and the definition of replacement asset period in subsection 995-1(1) of the ITAA 1997]***

Example 1.7 Access to CGT concessions

Returning to Example #.6, upon receiving the final payment under the look-through earnout right, Lucas chooses to access the small business rollover in relation to the gain.

Broadly, the small business rollover provides that, amongst other things a taxpayer may disregard a capital gain if:

- the gain arises from the disposal of an active asset; and
- the net value of the individual's CGT assets (together with the CGT assets of their connected and affiliated entities) does not exceed $6 million.

  If after accessing the rollover exemption a taxpayer does not acquire an appropriate replacement asset (broadly an active asset of equivalent value) within the replacement asset period they would be subject to additional tax.

Normally Lucas would be unable to access this exemption in respect of the full amount of the gain as under the CGT law he makes a binding choice not to apply the concession by not applying at the time when the gain first arose.

However, as the gain arose due to financial benefits in respect of a look-through earnout right this rule does not apply. The choice can be remade provided Lucas decides to revise the choice before he is due to lodge his income tax return for the 2019-20 income year – the income year in which he received the final financial benefit under the look-through earnout right.

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Similarly, generally the replacement asset period ends two years after the relevant CGT event occurred, so Lucas would be subject to additional tax if he has not already acquired a replacement asset. However, as the relevant CGT event was a disposal to which a look-through earnout right relates, this period is extended until 6 months after the expiration of the earnout right under the arrangement, allowing Lucas until December 2020 to acquire a replacement asset.

It should be noted that while Lucas's choice now means that he may have paid too much tax in 2015-16 as a result of the now disregarded capital gain, he is not entitled to interest from the Commissioner on this overpayment as it has arisen as a result of financial benefits under a look-through earnout right.

CGT concessions and the implications of changes to capital proceeds

1.93 The availability of some CGT concessions is linked to the capital proceeds of the CGT event or the income or turnover of a taxpayer in the relevant income year. Similarly, some CGT concession apply only where the taxpayer has a capital gain but not where the taxpayer has a capital loss or vice versa.

1.94 These characteristics in the past income year can change based on financial benefits that the taxpayer provides or receives in relation to a look-through earnout right.

1.95 As a result, a taxpayer may become eligible or cease to be eligible for a CGT concession as a result of these financial benefits. Such changes will require an alteration to the taxpayer's assessment or assessments reflecting the availability or loss of the concession in addition to the changes required as a direct result of the financial benefits under the look-through earnout right.

1.96 As previously outlined, a taxpayer will not be subject to shortfall interest charge (SIC) on additional tax that they must pay in relation as a result of providing or receiving financial benefits under a look-through earnout right. However, to the extent a taxpayer has accessed a concession for which they are ultimately not eligible due to these financial benefits, any additional tax that arises falls outside the scope of that exception and the taxpayer will be subject to SIC.

1.97 Additionally, while the receipt of financial benefits under a look-through earnout right may allow the taxpayer to remake choices and often extends the period in which a choice can be made, it does not entitle the taxpayer to undo the actions they have taken in that period. For example, if a taxpayer has made contributions to superannuation in order

to access a concession, they cannot withdraw these contributions now they are no longer available.

Consequential amendments

Consolidation

1.98 Subsection 705-65(5B) of the ITAA 1997 was inserted into the law to create special rules to deal with earnout arrangements in the context of consolidated groups.

1.99 Broadly, it requires consolidated groups to revise the allocated cost amount (ACA) of an entity that joins the group to take account of subsequent money or property provided in respect of the acquisition of a membership interest in the entity where the subsequent money or property was not taken into account in working out the ACA when the entity joined the group.

1.100 Prior to these amendments, there were concerns about the effectiveness of this section. As the provision only applies where amounts were not taken into account in determining the initial cost base, if the value of the right to future money or property is taken into account at that time, subsection 705-65(5B) of the ITAA 1997 would not apply.

1.101 However, as this measure will now mean that the value of the right is explicitly disregarded when determining the initial cost base, subsection 705-65(5B) of the ITAA 1997 will now operate as originally intended.

Contingent on economic performance

1.102 Contingent on economic performance is a defined term in the ITAA 1997. It generally bears its ordinary meaning, but specifically provides that the ability or willingness of an entity to meet obligations and the receipts or turnover of an entity or activity are to be disregarded in determining if a right is contingent on economic performance.

1.103 The first matter, disregarding the ability or willingness of an entity to meet an obligation to satisfy the right or provide the return is included for avoidance of doubt – a financial benefit contingent on the choice or capacity of another is not contingent on economic performance.

1.104 However, the second matter, disregarding receipts and turnover is a modification of the ordinary meaning. While there are many cases in which receipts or turnover may not link to economic performance, there

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are many other cases in which it can be an appropriate measure. This exclusion reflects the context of the use of the term within the ITAA 1997.

1.105 This restriction presents a problem for the current amendments, where the exclusion of measures of economic performance based on receipts and turnover would unduly limit the scope of the concession. At the same time, it would be problematic to create another term with the same meaning as the ordinary meaning of 'contingent on economic performance'.

1.106 To address this, a consequential amendment has been made to remove the existing definition of 'contingent on economic performance' so that the term now bears its ordinary meaning. Existing references to 'contingent on economic performance' have been replaced by the new defined term 'contingent on aspects of economic performance', which is defined in exactly the same way as 'contingent on economic performance' was previously. ***[Schedule #, item 26, subsection 974-85(1) of the ITAA 1997]***

1.107 The power under the present law to modify the meaning of 'contingent on economic performance' by regulation will be retained in relation to the new term 'contingent on aspects of economic performance'. ***[Schedule #, items 18 to 25 and 27 to 31, paragraphs 25-85(2)(a) and 230-15(4)(a), subsection 230-460(13), table items 2 in subsections 820-930(2) and 974-75(1), paragraph 974-80(2)(a), the example in subsection 974-80(2), the heading to subsection 974-85(1), subsection 974-85(2), paragraph 974-85(4)(c), subsection 974-140(1) and the definitions of 'contingent on the economic performance' and 'contingent on aspects of the economic performance' in subsection 995-1(1) of the ITAA 1997]***

Other consequential amendments

1.108 A number of minor consequential amendments have been made to headings and guidance materials to reflect the consequences of the principal amendments made by this Schedule. ***[Schedule #, items 2, 5 and 7, item A1 in the table in section 116-25, the heading to section 104-190 and the definition of look-through earnout right in subsection 995-1(1) of the ITAA 1997]***

Application and transitional provisions

Application date

1.109 The amendments made by Schedule # will apply to all earnout arrangements entered into on or after 23 April 2015, the day when draft legislation to give effect to this measure was made public. ***[Schedule #, Item 37]***

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Transitional rules

Protection for taxpayer anticipation

1.110 These amendments do not apply prior to 23 April 2015. However, taxpayers that have reasonably and in good faith anticipated changes to the tax law in this area as a result of the announcement by the previous Government will have their current tax income preserved. ***[Schedule #, item 38]***

1.111 This protection measure introduced by this Schedule operates by reference to the protection measure introduced in relation to certain tax measures announced by previous Governments that did not proceed in section 170B of the ITAA 1936.

1.112 This approach protects taxpayers that have reasonably anticipated changes without requiring complex retrospective changes or requiring taxpayers to make amendments to comply with the specific provisions of the final law the detail of which could not have been anticipated.

1.113 As with this earlier measure, the protection will operate by placing a statutory bar on the Commissioner amending an income tax assessment in relation to a particular contained in a statement, to the extent that the particular represents the taxpayer's reasonable anticipation of the announced changes to the law and satisfies the timing conditions.

1.114 Amongst other things, the timing conditions for the earlier protection measure applied differently to events before and after 14 December 2013 (see subsection 170B(3) of the ITAA 1997). For the purposes of this measure, the timing conditions will apply differently based on whether events happened before or after 23 April 2015. Broadly, this means that the conditions will be satisfied if either:

- the statement is made between the date of the announcement and 23 April 2015 and if the statement was made in a return, the return was not be require to be lodged before 23 April 2015; or
- the statement is made in a return lodged on or after 23 April 2015, the return was not required to be lodged before that date, no prior return had been lodged or assessment made for that income year, and the statement relates to the application of the taxation law to events prior to 23 April 2015 or to which the taxpayer was committed prior to 23 April 2015.

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1.115 Also consistent with the prior measure, any protection under the measure will be lost if the taxpayer makes a statement for a later year of income that is not consistent with the anticipated amendments reflected in the taxpayers original statement in a way that is to the taxpayer's benefit. Assessments may be amended at any time to give effect to the loss of protection.

Example 1.8

On 14 February 2014, Lauren enters into an arrangement to sell her business, Trapeze Services, to Circus Ltd. As part of the sale, Circus Ltd agrees to provide two annual payments of up to $100,000 contingent on ticket sales and profitability of Trapeze Ltd over those two years.

Lauren lodges her 2013-14 tax return on 30 July 2015. In this return, she anticipates, that the announced measure relating to CGT treatment for earnout arrangements will apply this transaction, based on the original announcement on 11 May 2010 and the discussion paper issued on 12 May 2010.

As a result of this anticipation, Lauren does not include the value of the two future payments contingent on performance when determining her capital gains from the sale of Trapeze Services. Provided her anticipation is reasonable, Lauren will receive the benefit of the protection rule and the Commissioner will not be able to amend this assessment, even though the amendments made by this Schedule will not apply at this time.

In February 2015, Lauren receives the full $100,000 payment available under the earnout right for that year.

Lauren's return for the 2014-15 income year will be lodged after 23 April 2015. However, the timing rule means that Lauren will be protected if she lodges return on the basis of the law as she has anticipated it in her prior return and this anticipation was reasonable, as this will be a statement relating to circumstances prior to 23 April 2015.

Subsequently, in February 2016, Lauren again receives the full $100,000 available for that year.

In this case both the payment and the lodgement of the return occur well after 23 April 2015. However, again, Lauren will be protected against subsequent amendments by the Commissioner if she prepares her return on the basis of the law as she had previously anticipated. The statements in the return relate to the circumstances of her original transaction and the rights created under the transaction, to which Lauren was committed prior to 23 April 2015.

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It is open to Lauren to prepare either or both of these subsequent returns on a basis that is not consistent with the law as she had anticipated in her original return. However, if she does and this is not to her detriment, the protection measure will no longer apply in respect of the statements in any of Lauren's returns and the Commissioner will apply the law as it stood at those times.

1.116 This protection measure affects how the Commissioner will apply the law in relation to earlier periods but does not actually change the law in these periods and so does not strictly speaking have retrospective effect. Additional, while the measure may affect past liabilities, it does so only to the benefit of the taxpayer.

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