Greenwoods & Freehills

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Draft Ruling on the Taxation of Earn out Arrangements

On 17 October 2007, the Australian Taxation Office (the "**ATO**") released a new Draft Taxation Ruling (the "**Draft Ruling**") on the tax treatment of "earn out arrangements" – where, on the sale of a business or asset, some part of the agreed price is contingent on future economic performance.

The Draft Ruling alters quite significantly for a buyer some of the analysis of standard earn out arrangements expressed in an earlier ATO Ruling on the subject, and the Draft Ruling sets out for the first time the ATO's preliminary views on a "reverse earn out" arrangement.

An earlier Taxation Ruling dealing with standard earn out arrangements was withdrawn on the same day. This leaves taxpayers in a somewhat curious position until the Draft is finalised – the existing Ruling no longer applies, but the new document is merely a draft and Draft Rulings only protect a taxpayer against the imposition of penalties and interest, not tax, if the ATO subsequently decides to modify its position.

Submissions on the Draft can be lodged with the ATO by 30 November 2007.

1. Sale on credit v. a sale for an earn out right

Underlying the Draft Ruling is a difficult question of characterisation which the Ruling does not attempt to address – that is, whether the seller should be viewed as selling its business or asset for a price that is payable:

- entirely in cash, part of the cash being payable now and part being payable in the future; or
- partly by cash and partly by property (a so-called earn out right).

This distinction matters, for example, if the business or asset being sold was acquired prior to capital gains tax, the seller would enjoy some other concession or if the transaction occurs cross-border.

The former Ruling took the view that the price was paid in cash and property if the price was "contingent and unascertainable." The Draft Ruling does not rule on how to distinguish between the two transactions; it simply assumes the transaction in question is one where a business or asset has been sold for a price "that includes the creation of an earn out right …"

2. Standard earn out arrangements

A standard earn out arises where on the sale of a business or asset (commonly, a share or unit in an entity which owns a business) the seller receives a right to future payments that are contingent on the economic performance of the business or asset.

The tax treatment that the Draft Ruling proposes can be summarised as follows. So far as the seller is concerned:

- The earn out rights are considered to be property received by the seller as part of the proceeds of sale – in other words, the seller is treated as having sold the business or asset for cash, plus the earn out rights. The market value of the earn out rights will be included in calculating the net capital gain on the sale of the business or asset. The seller will therefore generally look to place a low value on the earn out right to defer tax, if possible.
- It follows that the earn out rights are also assets for CGT purposes acquired by the seller. The cost base of the rights is their market value.
- If the buyer has to make further payments under the earn out arrangements, this will constitute a cancellation of the relevant right, and so, to the extent that the payment received exceeds the seller's cost base in the right, the seller will trigger another gain. To the extent that the amount received is less than the cost base the seller will be entitled to a loss.
- Given that the earn-out right is a separate asset from the business or asset originally sold, any gain or loss made on the cancellation of the right has to be analysed separately from the consequences attaching to the sale of the underlying asset or business. For example, the cancellation of the earn out right would not enjoy pre-capital gains tax status or some other concession that might have attached to the business or asset. The cross-border consequences may also be different.

So far as the buyer is concerned, it is treated as having bought the business or asset for the cash paid and the market value of the earn out right it creates in the seller. Under the prior Ruling, the ATO used to take the view that the buyer simply acquired the business or asset for cash, some payable immediately and some paid later. The Draft Ruling changes that view. It now takes the position that the buyer gives an item of property – the earn out right – when it buys the business or asset and the market value of that item of property becomes part of the cost of the business or asset the buyer acquires. Accordingly the Buyer will look to ascribe as high a value as possible to the right.

This new approach is likely to have some interesting ramifications outside this immediate context. The ATO has taken the view elsewhere that where a new item of property is created in the seller, rather an existing item being transferred to the seller, the value of new item does not form part of the buyer's cost in any asset acquired. It is unclear whether this represents a new approach that will be adopted more widely or whether the ATO will confine its application only to the creation of earn out rights.

Another important implication of the new approach for the buyer is the impact it will have in a tax consolidation context – that is, where the buyer has acquired the shares in a company which becomes part of the buyer's tax consolidated group, and the buyer subsequently makes further

payments under an earn out arrangement. Under the ATO's former approach, paying additional amounts required the re-determination of the cost to be pushed down onto the assets of the target. Under the new approach, it seems that the cost to be pushed down onto the target's assets will now be fixed and will not need to be revisited as post-consolidation payments under the earn out right are made. The ATO's new approach would appear to render redundant specific amendments to the tax consolidation regime made in 2004 to accommodate the former approach. These amendments will now likely have little or no application.

The Ruling is curiously silent on what happens when the buyer satisfies its obligations under the earn out arrangement by making a further payment, or not, as the case may be. Under the former Ruling, any further cash payments were treated simply as an additional cost of the asset or business acquired. But by changing the view of the transaction – a purchase paid for in part with property – the issue clearly arises, what happens when that property – the buyer's obligation – is extinguished? In other words, what happens if the business is sold for $10m in cash and an earn out right worth $1m, and in a year's time, the buyer subsequently pays a further $1.5m (or nothing) when the earn out payment is quantified and paid? It seems clear that the ATO does not view the additional payment on performance of the earn out as generating more cost in the underlying business or asset.

The ATO's approach to this can possibly be inferred – it is not explicitly stated – from other parts of the Draft Ruling. Other parts of the Draft Ruling take the view that on creating the earn out right, the buyer should be viewed as borrowing money or obtaining credit from the seller. (They take this position so that the creation of the right does not trigger a capital gain for the buyer at the time that the earn out arrangement is entered.) If that is the preferred view at the time that the earn out is entered, presumably the ATO would consider the performance of the earn out to involve the repayment of that money or credit. This raises the unhappy possibility that the buyer might make a taxable gain, or be affected by the debt forgiveness rules, if the amount paid to extinguish its obligations under the earn out right is less than the value of the earn out right at the time of issue. Or if the buyer has to make a larger payment to discharge the its obligation, perhaps this is to be treated as a cost of obtaining that putative finance (although it clear that the earn out arrangement will not be treated as a financial arrangement under the new taxation of financial arrangements Bill). Another possibility is that the amount eventually paid is to be treated as unrelated to anything else for tax purposes – perhaps it is just a payment, and therefore, able to be recovered over 5 years under the "black hole" rules. The proper treatment of these payments needs to clarified.

In the case of a multi-year earn out, the tax treatment will depend upon whether the earn out constitutes one right to receive the payments or separate rights for each earn out payment. The Commissioner accepts that for compliance reasons the parties may treat the right to each separate payment as a discrete asset, rather than a part of a larger composite asset.

3. Reverse earn out arrangements

A reverse earn out arrangement is defined as a contract for the sale of a business or asset in which the seller accepts a nominated sum by way of consideration, but undertakes to pay an amount or amounts to the buyer calculated by reference to the earnings generated by the business or asset during a specified period after completion of the sale. Traditionally, any subsequent payments were treated as a reduction of purchase price. The ATO now adopts a different analysis.

The proposed tax treatment may be summarised as follows. So far as the seller is concerned:

- The consideration received on sale of the business or asset is treated as being in respect of two things – the business or asset, and the reverse earn out right which it created in the buyer. This has the effect that part of the cash received is not to be treated as proceeds of selling the business or asset. In other words, the seller collects $10m in cash, but only $9m is to be treated as proceeds of selling the business. Accordingly, one would expect that the seller will seek to ascribe a high market value to the reverse earn out right as it will result in a corresponding reduction in the amount of consideration received for the sale of the asset. This will result in the seller realising a smaller capital gain or a larger capital loss. As a result, the seller may receive a sum of money effectively tax free (at that time) to the extent it overvalues the earn out right.
- What happens to the other $1m? It might have been expected, given that the earn-out right is treated as a separate asset being provided by the seller along with the business or asset being sold, that the other $1m would be treated as a further gain made on the creation of the right. However, the ATO's new approach continues the idea that the creation of the reverse earn out right by the seller is the borrowing of money or obtaining credit. The result is that the seller does not trigger a capital gain in respect of the part of the proceeds it collects that are attributable to the right.
- Again, the Ruling is silent on what happens when if and when the seller makes payment to the buyer in satisfaction of its obligations under the reverse earn out. The ATO does not consider that the payment constitutes repayment of part of the purchase price, regardless of what may be expressed in the agreement. The arguments put forward by the ATO are not overly convincing. Presumably, assuming the ATO will be consistent in this, it should considered to be akin to repayment of the borrowing or credit, with the possibility of gain or loss arising, or debt forgiveness issues. Perhaps it is within the black-hole regime. Again, this needs clarification.

So far as the buyer is concerned:

- The buyer will be taken to have paid for 2 assets: the asset acquired under the sale agreement, and the reverse earn out right created in it by the seller.

- The payment by the seller in satisfaction of the earn out right will then trigger further capital gains tax consequences. If the amount received exceeds the value ascribed to that earn out right, the buyer will derive a capital gain. Similarly, if the buyer receives less than the value ascribed to the earn out right it will suffer a capital loss.

This position creates some difficulties, and perhaps unfairness, for the buyer. If the buyer undervalues the earn out right, it will have a higher cost in the assets acquired, which may result in higher trading stock or depreciable asset values, but the buyer is more likely to realise a taxable capital gain if an earn out payment is received. It has effectively over-paid for the assets it acquired. The impact of the ATO's analysis of the transaction is that the buyer keeps its higher cost in those assets but may have to suffer the effects an offsetting capital gain. On the other hand, if the buyer overvalues the earn out right, it will have understated its cost in the business or assets it acquired. While the buyer may realise a capital loss if the seller makes a modest payment which extinguishes the right to which the buyer ascribed a high value, it may be some time before the buyer is in a position to utilise such a loss.

4. Market values

The positions adopted by the ATO will lead to the buyer and the seller having conflicting interests in valuing earn out rights. As a result of the ATO's views, the parties may now be willing to record what they consider to be the market value of the earn out right in the relevant sale agreement. However, the tax legislation does not require the parties to agree on values. Under the self assessment system each party may nominate what they consider to be the market value of the right and base their tax calculations accordingly.

Taxpayers can either obtain a valuation from a qualified valuer or undertake their own computation of the value. The ATO may challenge the valuations especially if there is a big difference between the buyer's and the seller's value. Taxpayers should therefore obtain (and retain) a valuation at the time of the transaction to provide some measure of protection in any later audit.

For further information, please contact:

Melbourne

Toby Eggleston

toby.eggleston@gf.com.au

61 3 9288 1903

Greenwoods & Freehills

Sydney

Andrew White

andrew.white@gf.com.au

61 2 9225 5984

www.gf.com.au

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Greenwoods & Freehills Pty Limited

ABN 60 003 146 852

Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia

Facsimile (02) 9221 6516 Telephone (02) 9225 5955

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