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Yearning for Earnout Certainty

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The paper suggests that the approach adopted in the draft ruling is not always defensible by reference to statute or case law, and that it has failed to deal with important legal implications. In adopting a "deconstructionist" or "separate asset" approach (in contrast to a "look-through" or "underlying asset" approach), combined with a slavish yet not always consistent adherence to the letter of the law, the ATO has presented tax practitioners and their clients with a host of practical problems of interpretation and implementation that did not previously exist. As a result practitioners have been left in a state of considerable uncertainty. The paper suggests potential solutions to these problems, and argues that the final ruling will have to adopt a significantly different position in order to remove this uncertainty.

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In October 2007 the Australian Taxation Office (ATO) issued a draft Taxation Ruling (TR 2007/D10) which indicates the ATO's current view of the capital gains tax (CGT) implications for vendors and purchasers in business transactions commonly known as earnouts and reverse earnouts. This paper provides an analysis of the approach taken in that draft ruling, particularly by reference to the existing CGT legislative provisions and their interpretation in case law. It compares the ATO approach in this draft ruling with the approach to these sorts of transactions taken in previous rulings, and also considers and compares the tax treatment of such earnouts in comparable overseas jurisdictions.

The paper suggests that the approach adopted in the draft ruling is not always defensible by reference to statute or case law, and that it has failed to deal with important legal implications. In adopting a "deconstructionist" or "separate asset" approach (in contrast to a "look-through" or "underlying asset" approach), combined with a slavish yet not always consistent adherence to the letter of the law, the ATO has presented tax practitioners and their clients with a host of practical problems of interpretation and implementation that did not previously exist. As a result practitioners have been left in a state of considerable uncertainty. The paper suggests potential solutions to these problems, and argues that the final ruling will have to adopt a significantly different position in order to remove this uncertainty.



Yearning for Earnout Certainty

Introduction

Corporate acquisitions often pose significant problems for both the acquiring and the selling entities. For example, it is not uncommon to find that the parties to the transaction significantly disagree as to the value of the target entity, with the purchaser believing that the asking price is inflated, in contrast to the vendor's perception that the price is fair or even too low. In addition, purchasers are often concerned that key personnel (often owner-managers) will not remain with the target entity, or that if they do remain they will have little incentive or motivation to promote and deliver the sort of synergies expected of the acquisition.

These problems, referred to in the literature as the problems of asymmetric information and moral hazard¹, are often overcome through the use of earnouts – arrangements whereby the consideration to be paid for a business may involve additional and contingent payments based in some way on the future performance of that business. The parties to the transaction agree that the buyer will pay an additional amount in some agreed time frame based upon some agreed achievement of revenue, earnings or other performance measure. The contingent payments made under the earnout agreement therefore bridge the gap between what the vendor thinks the business is genuinely worth and what the purchaser considers is a reasonable price based on the expectation of future earnings. They also tie in and motivate key personnel in the transition phase.

An earnout usually involves

- the disposal of a business or business assets for consideration, some or all of which is deferred;
- the deferred consideration (as well as any fixed upfront consideration involved in the transaction) may be in the form of cash and/or scrip (or conceivably other property, though this is unlikely);
- the deferred amount is contingent upon some aspect of future business performance – the event giving rise to the amount may or may not happen such that the deferred amount is not certain as to receipt;
- nor is the deferred amount certain as to the amount that will be received, as it is calculable only when the event that gives rise to the deferred amount actually does happen.

In short, an earnout involves deferred consideration which is, at the time at which the earnout agreement is effected, contingent and unascertainable as to amount and receipt. An earnout can therefore immediately be distinguished from a transaction under which the total amount payable by the acquiring entity and receivable by the disposing entity is known at the time of the contract but is payable/receivable (in part

¹ See, for example, M. Cain, D.J. Denis and D.K. Denis, *Earnouts: A Study of Financial Contracting in Acquisition Agreements*, (April 26 2006), Purdue University Krannert School of Management Working Paper Series; and S. Blough, M. Glaser, O. Kiet and C.Scholz, How Earn-Out Clauses Can Shift Risks, *International Tax Review*, No.35 (Tax Reference Library: Transfer Pricing: 9th Edition), 2007.

or full) at a future date or dates. Such instalment transactions are not earnouts (although an earnout transaction may itself involve instalments).

Broadly consistent with this definition, the ATO defines 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.”² The same draft ruling then goes on to explain that 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 a sum in respect of that sale which is certain as to amount and as to receipt.”³

It should be noted, however, that the draft ruling recently issued only purports to deal with earnouts, in contrast to the ruling it replaces. Taxation Ruling TR 93/15, which was withdrawn on the day that the draft ruling was released, dealt with the “capital gains tax consequences of consideration comprising a lump sum plus a right to a contingent and unascertainable amount”. The more recent (draft) ruling is therefore more specific (and considerably lengthier) than the ruling it has replaced, and certainly does not cover precisely the same ground.

The draft ruling⁴ provides a simplified example of a typical standard earnout as follows:

“A seller wishes to dispose of all of the shares in a company which owns and operates a business.

The seller considers that the market value of the shares is \$600,000. This valuation is based on projections that the business will generate sales of \$450,000 per annum.

A potential buyer considers that the shares are worth an amount somewhere in the range of \$400,000 to \$600,000. The seller agrees to sell the shares to the buyer on terms that will take into account the performance of the business in the succeeding two years.

The parties enter into a contract in which the buyer agrees to pay the following consideration for the shares:

- *a lump sum of \$400,000; and*
- *50% of the amount by which its gross annual turnover exceeds \$250,000 in each of the next two years.*

Consistent with the seller's projections, in each of the next two years the gross annual sales of the business is \$450,000. Accordingly, the buyer is required to pay a further amount of \$100,000 at the conclusion of each of those years.”

The ATO’s draft ruling also introduces the concept of a “reverse earnout arrangement”, defined as “a contract for the sale of an asset in which the seller of an

² Draft Taxation Ruling TR2007/D10, at para 2.

³ Draft Taxation Ruling TR2007/D10, at para 3.

⁴ Draft Taxation Ruling TR2007/D10, at para 8.

asset accepts a nominated sum by way of consideration, but undertakes to pay an amount or amounts (post-sale payments) to the buyer calculated by reference to the earnings generated by the asset during a specified period after completion of the sale.”⁵ Again, a simplified illustration is provided⁶:

“A seller wishes to dispose of all of the shares in a company which owns and operates a business.

The seller considers that the market value of the shares is \$600,000. This valuation is based on projections that the business will generate sales of \$450,000 per annum.

A potential buyer considers that the shares are worth an amount somewhere in the range of \$400,000 to \$600,000. The buyer agrees to pay \$600,000, but wants an undertaking from the seller to pay him or her subsequent amounts on terms that will take into account the performance of the business in the succeeding two years.

The parties enter into a contract in which:

- *the buyer agrees to pay \$600,000 consideration for the shares; and*
- *the seller agrees to pay the buyer 50% of the amount (if any) by which the business turnover falls below \$450,000 in each of the two years following the sale.*

In the next two years, the gross annual business sales of the business are \$425,000 and \$435,000 respectively. Accordingly, the seller is required to pay to the buyer \$12,500 at the conclusion of the first year and \$7,500 at the conclusion of the second year.”

Reverse earnouts are obviously less common than standard earnouts,⁷ and are only incidentally dealt with in this paper.

Standard earnouts are neither new nor uncommon. There has, though, been a “significant ongoing trend toward greater use of earnouts in both stock and asset transactions”⁸ in recent years. Various estimates in the USA⁹ suggest that earnouts were involved in between 3% and 6% of all mergers and acquisitions in the 1990s and early 2000s, with a probable increase thereafter as a result of the adoption of FASB 141 in July 2001 (which removed accounting obstacles associated with contingent payments in earnout contracts). The figure is likely to be similar, if not larger, in Australia and other comparable jurisdictions.

⁵ Draft Taxation Ruling TR2007/D10, at para 4.

⁶ Draft Taxation Ruling TR2007/D10, at para 9.

⁷ Indeed, neither the term nor the concept was familiar to overseas practitioner colleagues, nor to many Australian colleagues, who were consulted on the matter.

⁸ J. Koenig and C. Boise, “Contingent Consideration: The Taxation of Earnouts and Escrows”, *Mergers and Acquisitions: The Monthly Journal* Vol 2 No 3, 2001 at 3.

⁹ S. Datar, R. Frankel and M. Wolfson, “Earnouts: The Effects of Adverse Selection and Agency Costs on Acquisition Techniques”, *The Journal of Law Economics and Organization* Vol 17 No 1, 2001 at 216; M. Cain, D.J. Denis and D.K. Denis, *Earnouts: A Study of Financial Contracting in Acquisition Agreements*, (April 26 2006), Purdue University Krannert School of Management Working Paper Series, at 4.

The literature suggests¹⁰ a number of features that characterize earnouts:

- they are more typically found where the target is a private company or a subsidiary of a public firm rather than a directly quoted company;
- the performance measures vary. Some measure of profitability (such as cash flow, pre-tax income, gross profit, net income, earnings per share) was used in just over half (52%) of a sample of 990 earnouts in the USA in the period from 1994 to 2003; sales were used as the performance measure in 32% of the cases; share price in 1.2% of the cases; and non-financial measures (such as contracts secured, clinical trial completion) in 12.2% of the cases;¹¹
- the typical duration of the earnout period is between 2 and 3 years. In the USA sample of 990 acquisitions the average duration of the earnout (ie the period over which the performance was measured, usually at annual rests) was 2.57 years;¹²
- the form of payment for the contingent amount can vary. The most common form is cash (39% in the USA study); payment by way of common equity constituted 29% of cases; and there was a mixture of cash and equity in 26% of cases;
- earnouts are more typically found where there is a greater degree of uncertainty about the target's value. The greater the uncertainty in valuations, the greater the amounts likely to be involved in the earnouts, the shorter the earn-out period involved, the more likely the use of scrip rather than cash as the method of payment, and the more likely that sales would be used as the performance measure;
- earnouts involving targets with perceived greater growth potential or opportunity tend to be larger and have longer earnout periods and are more likely to be paid in the form of equity in the acquiring entity.

In summary, the key features of earnouts can vary significantly from case to case – there is not a “one size fits all” approach to the financial contracts involved. As noted by Blough et al:¹³ “[e]mpirical analysis of earn-out clauses between third parties has revealed considerable heterogeneity in the terms of earn-out contracts, the profit level indicator, the period over which performance is measured, and the form of payment for the earn-out.”

While commercial considerations are ultimately paramount in determining the nature of the agreement, the commercial tension between buyer and seller is inevitably compounded by the tax implications that arise as a result of the involvement of contingent and unascertainable consideration in the transaction.

¹⁰ M. Cain, D.J. Denis and D.K. Denis, *Earnouts: A Study of Financial Contracting in Acquisition Agreements*, (April 26 2006), Purdue University Krannert School of Management Working Paper Series, at 2-8 and 22.

¹¹ See M. Cain, D.J. Denis and D.K. Denis, *Earnouts: A Study of Financial Contracting in Acquisition Agreements*, (April 26 2006), Purdue University Krannert School of Management Working Paper Series, at 7.

¹² See M. Cain, D.J. Denis and D.K. Denis, *Earnouts: A Study of Financial Contracting in Acquisition Agreements*, (April 26 2006), Purdue University Krannert School of Management Working Paper Series, at 7.

¹³ S. Blough, M. Glaser, O. Kiet and C.Scholz, How Earn-Out Clauses Can Shift Risks, *International Tax Review*, No.35 (Tax Reference Library: Transfer Pricing: 9th Edition), 2007, at 29.

Those tax implications are not straightforward, no matter in which taxing jurisdiction the transaction occurs. One of the earlier Supreme Court tax cases in the USA¹⁴ concerned the tax treatment of contingent consideration received by the seller of equity in a corporate takeover, and in the UK the House of Lords has also had occasion to consider the tax implications of such transactions.¹⁵

This paper is principally concerned with the tax implications of such earnouts in business acquisitions and disposals, whether involving assets or shares. The analysis is conducted primarily from the perspective of the capital gains tax (CGT) implications applying to the acquiring and disposing entities.¹⁶ It is conceivable that in certain circumstances the transactions might be on revenue account and therefore have implications for ordinary income or deductions rather than CGT. The draft ruling¹⁷ mentions *Chadwick v Pearl Life Insurance* [1905] 2KB 507 in this connection. Other cases would also be relevant. So far as the seller is concerned, *Moneyman Pty Ltd v FCT* (91 ATC 4019) is authority for the revenue treatment of deferred consideration in the form of monthly receipts for what the taxpayer claimed was the disposal of a capital asset; and from the purchaser's perspective, *Cliffs International Inc v FCT* (79 ATC 4059), in which deferred payments relating to the exercise of a right to acquire shares in a mining company based on a price per ton of iron ore mined were held to be payments on revenue account, would be authority for the proposition that the purchaser might be able to obtain a revenue deduction for such payments. But the possibility of revenue treatment of earnout transactions is not explored further in this paper.

The next section of the paper examines the CGT implications of earnouts, by reference to statute and case law, from the perspective of both the buyer and the seller. In so doing it contrast the position initially adopted by the Australian Tax Office (ATO) with its more recent pronouncements, and concludes that the ATO's new position (based on a separate asset analysis) is fundamentally misguided, and that it gives rise to many uncertainties and problems that did not hitherto exist. This view is shared by the professional bodies, who note that they have "some significant concerns about the practical application of the approach taken in the Draft Ruling".¹⁸ This leads into a section which explores an alternative to the separate asset approach adopted by the ATO – the underlying asset approach to the characterisation of certain commercial transactions in the context of CGT. The following section considers how some jurisdictions with broadly comparable tax regimes deal with the tax implications of earnouts. The concluding section makes some suggestions, based on the analysis of statute, case law and practice in Australia and comparable jurisdictions, as to how the tax implications of earnouts might more sensibly be addressed in Australia.

¹⁴ *Burnet v Logan* 283 US 404 (1931).

¹⁵ *Marren v Ingles* [1980] 3 All ER 95.

¹⁶ For a comparison of the way in which the CGT and Goods and Services Tax (GST) provisions operate and interact in relation to contingent and unascertained consideration, see L. Wolfers, A. Curkovic and K. Wilson, Contingent Confusion and Unascertainable Uncertainty, *in Tax Magazine*, June 2005.

¹⁷ Draft Taxation Ruling TR2007/D10, at para 10

¹⁸ Joint Submission by The Institute of Chartered Accountants in Australia, CPA Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia on Draft Taxation Ruling TR2007/D10, dated 14 December 2007, at para 1.

The CGT treatment of earnouts in Australia

The CGT provisions will generally apply to earnout transactions. For transactions where the contract was entered into in the period from 20 September 1985 to 30 June 1998, Part IIIA of Income Tax Assessment Act 1936 would have been the relevant provisions; thereafter Parts 3-1 and 3-3 of Income Tax Assessment Act 1997 apply. The analysis of the application of the provisions is best conducted separately for buyer and seller, referring primarily to the current 1997 provisions. References are to the 1997 Act unless otherwise specified.

CGT implications: the seller's perspective

The CGT provisions only apply if there is a CGT event (sec 100-20). Once an event happens, the rules for the relevant CGT event are applied to calculate the capital gain or loss from that event, and any exemptions or concessions that may be available are taken into account in calculating the net capital gain or capital loss for the income year.

In the view of the ATO, the disposal of a business or business assets (referred to hereafter as “the original assets”) in an earnout transaction potentially triggers a CGT event on two or more occasions. In the first place, and at the time the contract for the disposal of the business or assets is entered into, an A1 CGT event happens (sec 104-10). Subsequently it is the view of the ATO that there may be further CGT events as the seller’s earnout right (the right to future and unascertained consideration, created in the seller at the time of the initial contract) is dealt with. These potential events are considered in turn.

Disposal of the original assets

The disposal of the original assets clearly constitutes the change of ownership of the assets necessary to trigger CGT event A1. There is a capital gain if the capital proceeds from the disposal exceed the cost base (sec 104-10(4)). Capital proceeds are the total of the money the seller receives, or is entitled to receive, together with the market value of any property the seller receives or is entitled to receive, in respect of the event happening (sec 116-20). The cost base constitutes the five elements determined by sec 110.

The ATO has consistently maintained,¹⁹ and arguably with good authority,²⁰ that the existence of the earnout arrangements in the disposal of the original asset has the effect of creating, in the seller, an earnout right (the right to future and unascertained consideration). This earnout right is property, and its market value is thus part of the capital proceeds for the disposal of the original assets. On this view, therefore, the capital proceeds to be taken into account in the calculation of the gain or loss on the disposal of the original assets comprise any fixed amount the vendor receives or is entitled to receive, together with the market value, at the time of contract, of the earnout right.

¹⁹ Initially in Taxation Ruling TR93/15 at para 17; more recently in Draft Taxation Ruling 2007/D10 at paras 91-100.

²⁰ *Marren v Ingles* [1980] 3 All ER 95.

Events affecting the earnout right(s)

Subsequent dealings with the earnout right may, in the view of the ATO, trigger further CGT events. For example, given that the earnout right is property, it may be assigned by the seller of the original assets, triggering another A1 CGT event. Alternatively the seller might trigger CGT event E1 (sec 104-55) by declaring himself or herself to be trustee of the right for another entity. More likely, however, is that CGT event C2 (sec 104-25) will apply as a result of the earnout right ceasing to exist. It will come to an end either by being discharged or satisfied by the payment of additional amounts (the previously contingent and unascertained amounts) by the buyer, or by the earnout right expiring without triggering additional payments.

The cost base of the earnout right, for the purposes of working out any capital gain or loss that may arise in these subsequent events, will be 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 (sec 112-30(1)). In practice, the Commissioner accepts an approach in which:

- “the amount is determined by subtracting from the market value of the original asset at the contract date any money received or receivable on the disposal; or
- the amount is taken to be an amount equal to the market value (on acquisition) of the earnout right.”²¹

This somewhat simplified method to value earnout rights rather overlooks the fact that the very reason for the existence of the earnout in the first place is the inability of the two parties to the transaction to agree on the market value of the original assets! It ignores “the threshold problem that earnout arrangements are used because of the lack of mutual agreement as to the market value of the underlying asset, being the goodwill inherent in the sale of the relevant business or shares”.²²

The calculation of the capital gain or loss so far as CGT events relating to the earnout will depend upon whether the amounts due are payable in a single lump sum or by way of a number of progressive payments. Where the payment under the earnout arrangement is made as a single lump sum, the capital gain is simply the difference between that amount and the cost base of the earnout right.

The position where progressive payments are involved is more complex, and will ultimately depend upon whether the totality of rights under the earnout agreement is a single asset (the preferred ATO position²³) or each right to a progressive payment is a separate CGT asset. Where the “legal form of the agreement provides for separate payment rights (for example, in relation to particular years), and the seller wants to treat the rights as separate CGT assets, the Commissioner will not generally seek to disturb such treatment. The Commissioner recognises that compliance cost savings may result from this approach over the 'single asset' approach [involving multiple part

²¹ Draft Taxation Ruling TR2007/D10, at para 104.

²² Joint Submission by The Institute of Chartered Accountants in Australia, CPA Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia on Draft Taxation Ruling TR2007/D10, dated 14 December 2007, at para 81.

²³ Draft Taxation Ruling TR2007/D10, at para 114.

disposals] which would usually require that the right be valued several times as it progressively ends.”²⁴

Increased compliance costs are by no means the only adverse implication of the approach favoured by the Commissioner whereby multiple CGT events potentially occur as payments relating to the earnout right(s) are progressively received. The two-stage “separate asset” interpretation (CGT event on disposal of the original assets followed by one or more CGT events on receipt of contingent consideration) can also have adverse implications for the vendor in relation to stranded losses and denial of access to concessions that might otherwise be available to the vendor.

The stranding of losses will occur where earnouts rights are initially over-valued or the business subsequently under-performs, with the result that capital losses are crystallised in later income years after capital gains have been realised (and the tax paid) in earlier years. The lack of any prior year amendment provision to the calculation of the gain on the original assets, or of any carry back mechanism for such losses, and the inability to set off such losses except against capital gains in current or future years, can be potentially disastrous.

The existence of an asset (the earnout right) separate from the original asset and only created at the time of the disposal of the original asset also means that vendors of pre-1985 businesses will never be able to claim grandfathered status in so far as the capital gain relates to the earnout right, nor the CGT discount in circumstances where the earnout right is in existence for less than one year. Arguably, the loss of either or both of these concessions is not likely to have much significant impact – not many businesses can still claim pre-1985 status nowadays and not many earnouts will be based on performance periods of less than one year. Of much more significance, however, is the ATO suggestion that vendors will not be able to access any of the small business concessions in so far as the gains arising from the earnout right are concerned. The Draft Ruling notes that:

“[u]nlike the original asset, an earnout right will not satisfy the definition of 'active asset' under section 152-40. This is because:

(a) An earnout right is not used, or held ready for use, by the seller in the course of a carrying on a business by the seller or by a small business affiliate thereof (paragraph 152-40(1)(a));

(b) an earnout right is not an intangible asset inherently connected with a business carried on by the seller or a small business affiliate thereof (paragraph 152-40(1)(b)); and

(c) an earnout right is in the nature of a 'financial instrument' and is excluded from the definition of 'active asset' by the exception in (paragraph 152-40(4)(d)).”²⁵

Presumably the ATO has adopted the view, so far as the first two reasons for the denial of access to the small business concessions are concerned, that the vendor has already terminated the business at the point when the earnout right is created. This may be correct but does rely on the view that the right to the unascertained and contingent consideration only arises after the disposal of the original assets.

²⁴ Draft Taxation Ruling TR2007/D10, at para 115.

²⁵ Draft Taxation Ruling TR2007/D10, at para 124.

Moreover, even if technically the provisions do operate in such a way as to deny access to the concessions on part of the consideration for the sale of the business, it is difficult to see, from a policy perspective, why this is the case. Future and unascertained amounts relating to the value of the business are as much proceeds from the sale of the business as are fixed and non-contingent amounts.

There is another adverse outcome where the vendor's capital proceeds include shares in the purchaser's company and the vendor wishes to take advantage of the scrip for scrip roll-over (subdiv 124-M). The ATO has indicated²⁶ that the relief is not available where there are rights to receive shares, the number of which cannot be ascertained until a future date. This constitutes "ineligible proceeds".²⁷

In the light of these potentially adverse outcomes for the vendor, the question does arise as to whether the "separate asset" two stage approach favoured by the ATO (CGT event A1 on the original assets followed by (usually) C2 on the earnout right) is correct in law. This issue is returned to later in the paper after the CGT implications for the buyer have been explored.

CGT implications: the purchaser's perspective

The acquisition of a business or business assets (the original assets) by the purchaser in an earnout does not trigger any immediate CGT event or events. It does, however, have implications for the cost base of the purchaser of the original assets acquired, and those implications have to be addressed at the time at which CGT event(s) subsequently occur.

The draft ruling issued by the ATO in 2007 adopts a different approach to the cost base issue from that adopted in Taxation Ruling TR93/15. In the earlier ruling the ATO had argued that the cost base of the original assets comprised two or more distinct components:

- any initial monetary payment comprising a lump sum or other initial payment;
- any subsequent payments under the earnout agreement

All of these amounts were included in the first element of the cost base of the original asset ("the amount of any consideration in respect of the acquisition of the asset": secs 160ZH(1)(a) and 160ZH(4)(a)), albeit they were paid at different times and therefore entered the cost base at different times. Most importantly, TR93/15 indicated that the contingent obligation to pay an amount in respect of the earnout right was not property,²⁸ and that therefore the cost base of the original assets did not comprise both the money paid and the market value of any earnout right created. The rationale for this was stated as follows²⁹:

"If the buyer agrees to pay a contingent and unascertainable amount, a proprietary right is created in the seller by the buyer. The buyer creates an

²⁶ ATO Interpretative Decision 2002/100.

²⁷ See P. McKnoulty, *Tax Issues for Private Equity Transactions*, TIA National Convention, Adelaide, March 2008 for suggestions as to how this potentially adverse outcome can be overcome.

²⁸ Taxation Ruling TR93/15, at para 8.

²⁹ Taxation Ruling TR93/15, at para 27.

obligation contingent on the happening of an event. The buyer does not give the seller any property that was previously owned by the buyer, even though what is given becomes the property of the seller. The buyer simply has no property to dispose of and nothing can be transferred or conveyed from the buyer. It has been judicially decided that property can be acquired by one person without there being a corresponding disposition of that property by another person. Consequently, the buyer has not given property as part of the consideration (subsection 160ZH(4)) (Commissioner of Taxes (Q) v. Camphin (1937) 57 CLR 127; (1937) 4 ATD 315; Ord Forrest Pty Ltd v. FC of T 74 ATC 4034; (1974) 4 ATR 230; Allina Pty Ltd v. FC of T 91 ATC 4195; (1991) 21 ATR 1320)."

Draft Taxation Ruling TR2007/D10 adopts a very different approach. It determines that when a purchaser acquires the original assets in exchange for a monetary payment plus the granting of an earnout right to the seller, the first element of the purchaser's cost base comprises both any initial lump sum payable plus the market value of the right (worked out at the date of contract). Any amounts subsequently paid by the purchaser under the earnout agreement are not included in the cost base. The ATO now argues that these subsequent payments are not paid to acquire the original assets, but are paid to discharge the buyer's obligation under the earnout agreement.³⁰

Justification for this *volte face* gives the ATO some uncomfortable moments in the draft ruling.³¹ The revised argument, suggesting that the market value of the earnout right has to be taken into account in the calculation of the cost base but that subsequent payments under the earnout do not, is based upon the wording of sec 110-25(2) and the authority of *Dingwall v FCT*.³² Essentially it is argued, in contradistinction to the explanation in TR93/15, that property is given when the buyer creates an earnout right in the seller, even though the property (the rights under the earnout) is not transferred or conveyed from the buyer to the seller. The ATO had previously argued that because there was no such transfer, property was not given and so the market value of the earnout right could not be taken into account in the cost base.

The previous ATO position, whereby the cost base of the purchaser was steadily built up as payments were made, was a tenable position in law and had the advantage of being a practical and workable solution to a difficult problem. In adopting its new position the ATO argues that it has achieved a greater degree of symmetry³³ between the CGT positions of buyer and seller and persuades itself that its new interpretation is more technically correct. Whether symmetry in the tax implications for those at the two ends of the transaction is either necessary or desirable is arguable. That matter is dealt with later in the paper. What is plain, however, is that the new approach has two direct consequences which are themselves problematic.

In the first place the ATO fails to address the issue of the tax implications for the purchaser in situations where subsequent payments made under the earnout agreement differ from the market value of the earnout rights. What happens where the purchaser

³⁰ Draft Taxation Ruling TR2007/D10, at paras 24 and 25.

³¹ Draft Taxation Ruling TR2007/D10, at paras 129 to 136.

³² 95 ATC 4345.

³³ To the extent that symmetry can be relative.

subsequently pays an amount which exceeds the market value of the right, or which is less than the market value of the right? In the former case the purchaser would presumably want relief, somewhere, for the additional payments. In the latter case, would the purchaser's cost base need to be reduced, or would the purchaser potentially be exposed to additional taxation as a result of the "windfall" of not having to pay as much as might otherwise have been contemplated (and for which cost base relief has been given) under the earnout arrangements?

The ATO ruling provides little certainty on either of these scenarios. It makes it clear that the payments by the buyer of an amount or amounts by way of discharge of an earnout right, or the expiry of an earnout right without payment, has no effect on the buyer's cost base for the original asset.³⁴ That much is certain in the view of the ATO, and may represent good news for the purchaser where subsequent earnout discharge payments are less than the initial valuation of the earnout right, but bad news where subsequent earnout payments exceed the initial valuation.

The ATO argues that such payments cannot be part of any of the five elements of the cost base of the original assets for a variety of reasons:³⁵

- they are not part of the first element (sec 110-25(2): money or property paid or payable in respect of acquiring the original assets) because they are incurred to discharge a liability that is independent of the obligation to pay the purchase price of the original assets;
- they are not part of the second element (sec 110-25(3) and sec 110-35: incidental costs) as earnout payments are not incidental costs. The term incidental costs is the subject of a strict definition in subsection 110-35(1) which does not encompass payments of this nature;
- they cannot be considered to be costs of owning the asset for the purposes of the third element (sec 110-25(4));
- they are not incurred for the purpose or expected effect of increasing or preserving the original asset's value, and nor do they relate to installing or moving the original asset (sec 110-25(5)); and
- they cannot be considered to have been incurred to establish, preserve or defend the taxpayer's title to, or a right over, the asset for the purposes of the fifth element (sec 110-25(6)).

There is little doubt that the ATO is correct in suggesting they cannot be part of the second element, and the ATO is also probably on firm ground in suggesting the third and fifth elements are not applicable. There may be arguments that cannot so lightly be dismissed, however, that the payments have been made under the first, or possibly the fourth elements, particularly if an underlying asset approach (dealt with below) is acceptable.

So, if subsequent payments by the purchaser are not dealt with under the cost base provisions that relate to the original asset, where are they potentially dealt with? The ATO ruling is remarkably silent on this issue, but there would appear to be a number of possibilities.

³⁴ Draft Taxation Ruling TR2007/D10, at para 137.

³⁵ Draft Taxation Ruling TR2007/D10, at paras 138-141.

One possibility is that the payments under the earnout arrangement form the cost base of some asset other than the original asset. The difficulty with this argument is that the purchaser does not acquire a CGT asset; only an obligation (possibly to have to pay the contingent amounts) is acquired. In the absence of any CGT asset it would appear difficult to provide relief for any capital loss, or to tax any capital gain, under the CGT provisions.

A second possibility is that any subsequent payments made by the purchaser are deductible under the general deduction provisions (sec 8-1), or as a financing cost (sec 25-25), or – failing that – under the “business related costs” rules of sec 40-880 – as “blackhole expenditure”. This latter provision would permit the contingent payments, to the extent that they are “business capital expenditure” and not otherwise deductible, to be deducted over a five year period. All relevant conditions of the section appear to be satisfied. Section 40-880(5)(f) would have the effect of excluding from the allowable deduction any amount that had already been taken into account in working out the amount of a capital gain or loss. In other words, there would only be blackhole deductions for expenditure that exceeded the market value of the earnout right granted by the buyer to the seller.

To the extent that any earnout payments were less than the market value of the earnout right already taken into account in determining the cost base of the original assets for the purchaser, the general and specific deduction provisions would not apply. There is, however, the unhappy prospect that other provisions might come into play to tax the purchaser to the extent that earnout payments actually made are ultimately less than the market value of the earnout right. This is explained by Eggleston and Cooper³⁶ as follows:

“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. (The ATO takes 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. The assumption is that CGT event D1 would otherwise happen when the buyer creates this right in the seller, and would, apparently receive the property it acquired as the proceeds of creating that right!)

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 [Schedule 2C, Income Tax Assessment Act 1936] 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.”

It will remain to be seen whether any, or even all, of these possibilities for dealing with the potential mismatch between the valuation of the earnout right for original

³⁶ T. Eggleston T and G. Cooper, “New Draft Ruling on the Taxation of Earnout Arrangements”, *Thomson Weekly Tax Bulletin* Issue 46, 2 November 2007.

asset cost base purposes and the subsequent payment of amounts under the earnout right itself, is ever put to the test. For the moment, uncertainty reigns.

The second major difficulty with the approach that has been suggested in the draft ruling is alluded to in parenthesis in the quote above. As a result of slavishly following the CGT events approach now found in Parts 3-1 and 3-3, the possibility of an entirely counter-intuitive CGT event D1 happening for the buyer has to be dealt with. Effectively, sec 104-35 would operate to impose a CGT liability on the buyer as a result of the buyer having created a contractual or other legal right (the earnout right) in the seller. The capital proceeds would be the market value of the property received for the granting of the right (in other words, some or all of the market value of the business or business assets being acquired by the purchaser), with only incidental costs set off against those proceeds. The result would be a very significant capital gain under CGT event D1 on the purchaser.

In order to avoid this unwanted (and entirely inappropriate) outcome, the draft ruling gleefully settles upon the exception in sec 104-35(5)(a): CGT event D1 does not happen if “you created the right by borrowing money or obtaining credit from another entity”. Somewhat tortuously the draft ruling argues³⁷ that the exception applies. In other words, the creation of the earnout right in the seller is the equivalent of borrowing money or obtaining credit so far as the buyer is concerned.

An alternative: the underlying asset approach

At the heart of the problems thrown up by the draft ruling is a change in emphasis by the ATO from a “look-through” or underlying asset approach to a “deconstructionist” or separate asset approach to the transactions involved. The ATO has always applied the separate asset approach to the seller in a standard earnout, despite submissions by the professional bodies that such an approach should be abandoned.³⁸ But the ATO now proposes to extend the separate asset approach to the treatment of the buyer under a standard earnout arrangement, and also to both buyer and seller under a reverse earnout arrangement.

In the light of this change of focus, the paper now considers more closely the arguments relating to the look-through (underlying asset) approach.

The ATO notes that the look-through approach, under which it would be possible to “look-through” the earnout right to the amounts (if any) subsequently paid under it as being capital proceeds paid in respect of the disposal of the original asset, is informed in large part by the approach taken by the UK High Court in *Zim Properties Ltd v Procter (Inspector of Taxes)*.³⁹

In that case, it fell to the court to determine from which asset a settlement sum received from solicitors as a result of their negligence in a transaction involving the

³⁷ Draft Taxation Ruling TR2007/D10, at paras 142-147.

³⁸ See, for example, para 2 of the Joint Submission by The Institute of Chartered Accountants in Australia, CPA Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia on Draft Taxation Ruling TR2007/D10, dated 14 December 2007.

³⁹ 58 TC 371.

disposal of property was derived: the underlying real property or the taxpayer's right to compensation. Warner J considered that the choice of which was the most relevant asset depended on the "reality of the matter" and acknowledged the availability of a "look-through approach" in appropriate circumstances. However he concluded on the facts before him that the settlement amounts paid by the solicitors were not derived from the real estate but were derived from the right to sue, which was itself an asset.

In *Zim Properties* Warner J said:

"We have, however, to look at the question in the light of the Montgomery case, where Walton J ([1975] STC 182, [1975] Ch 266) held that the derivation of assets could not be traced back in the manner of an abstract of title and that the question to be asked was: 'From what asset . . . was the capital sum . . . derived? ... In some cases this may be as difficult to discover as it was to find the source of the Nile--and as controversial..."

The ATO has used this case, and cases such as *Tuite & Anor v Exelby & Ors* (93 ATC 4293) and *Case Z21* (92 ATC 218), as authority to adopt an underlying asset or look-through approach in particular circumstances. For example, in Taxation Ruling TR 95/35 (dealing with compensation and damages) the Commissioner stated that one of the principles underlying the interpretation of CGT law is the "most relevant asset approach". This approach is described as 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.

This general principle was also applied in Taxation Ruling TR 1999/19 involving a "continuum of events approach" to the issue of forfeited deposits. This approach provides that it is 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. It states that, depending on the circumstances, where a vendor of land retains a forfeited deposit, it may properly be regarded as part of the proceeds of a later, successful sale of that land, rather than from the disposal of contractual rights (or a right to compensation) under the original, failed contract of sale.

The Professional Bodies also note⁴⁰ that a look-through approach has been adopted by the ATO in the context of a number of Taxation Determinations, including TD31 (receipt by a taxpayer of insurance proceeds) and TD57 (compensation for uninsured items).

The ATO argues⁴¹ that

"in the case of earnout arrangements, the "reality of the matter" (to use the language of Warner J in Zim Properties) is that the parties have entered into a financial arrangement that is independent of the sale transaction from which it arises. The mere fact that the earnout arrangement has its origins in the

⁴⁰ Joint Submission by The Institute of Chartered Accountants in Australia, CPA Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia on Draft Taxation Ruling TR2007/D10, dated 14 December 2007, at para 61.

⁴¹ Draft Taxation Ruling TR2007/D10, at paras 88-89.

sale of the original asset is not sufficient justification for treating the earnout arrangement as a merely subordinate part of a larger transaction.”

The ATO further contends:

*“An earnout arrangement is not merely a mechanism by which the parties agree to set an appropriate amount of compensation for the assets delivered in the contract. The deferred payments are not, as a matter of substance, made in respect of the acquisition of those assets. They are paid in respect of a separate obligation under which the seller stands to make a financial gain depending on the economic performance of an asset which the seller has ceased to own. In these circumstances, the CGT provisions recognise that what the buyer has given in respect of the acquisition of the original asset is property in the form of a promise to pay an indeterminate amount of money. Similarly, the CGT provisions recognise that the seller has received property in the form of a right to receive an indeterminate amount of money.”*⁴²

With respect, there are strong grounds for arguing that the payments of the contingent and unascertainable amount do derive directly from the disposal of the original or underlying assets. “The commercial reality of earnout arrangements in relation to sales of businesses is that they are typically used as mechanisms to quantify the goodwill of a business in order to settle on the total amount of the sale proceeds.”⁴³ They are part of the amounts received by the seller and paid by the purchaser for the business or business assets, albeit they are incapable of quantification at the time of the disposal. They are part of a continuum of events that begins with the negotiations for the sale of the original assets and ends when all consideration (ascertained and unascertained at the time of that original disposal) has been settled. The contingent and unascertained amounts are carved into a separate package or arrangement only because there is some doubt, in the minds of both buyer and seller, as to the true value of the assets being sold. But they still derive, if subsequently paid, from the disposal of the original assets.

As the Joint Submission by the Professional Bodies further notes:⁴⁴

“The reality of the matter (the key analytical approach as discussed in the Draft Ruling) is that an earnout...represents the sale proceeds of a business/share sale in the same manner as a fixed price sale contract...” and

“From an economic and commercial perspective, earnout payments are inextricably linked to the sale/purchase of the underlying asset. The full amount of any earnout paid/received should be recognised as consideration paid/received in respect of the underlying asset.”

⁴² Draft Taxation Ruling TR2007/D10, at para 89.

⁴³ Joint Submission by The Institute of Chartered Accountants in Australia, CPA Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia on Draft Taxation Ruling TR2007/D10, dated 14 December 2007, at para 3.

⁴⁴ Joint Submission by The Institute of Chartered Accountants in Australia, CPA Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia on Draft Taxation Ruling TR2007/D10, dated 14 December 2007, at paras 3 and 37.

Marren v Ingles is relied upon by the ATO as authority for not following the underlying asset or look-through approach it has adopted elsewhere.⁴⁵ It is certainly good authority for the fact that an earnout right can be a separate asset. But that is not the same as therefore concluding that the underlying asset approach cannot be used. As the Joint Submission by the Professional Bodies makes clear:⁴⁶

“We note that in that case [Marren v Ingles] the parties agreed to adopt a separate asset approach for the purpose of determining the capital gains tax on the disposal of the share – what was at issue was the capital gains tax treatment on the subsequent satisfaction of the earnout. On the foundation that separate asset approach was applied in respect of the underlying asset, it is understandable how the Court of Appeal and the House of Lords came to their decisions to maintain a separate asset approach in respect of the satisfaction of the earnout”.

In summary, a strong case exists for the adoption of a look-through or underlying assets approach to the CGT implications of earnout arrangements. It is certainly at least as strong a case as that which exists in favour of the separate asset approach. And, if an underlying asset approach were to be adopted in Australia, many of the problems and uncertainties raised by the adoption (by the ATO) of the deconstructionist or separate asset approach would not arise.

In the light of the uncertainty that currently surrounds the CGT treatment of earnout arrangements in Australia, it may be useful to refer to the law and practice in comparable overseas jurisdictions to see if any guidance may be forthcoming.

The tax treatment of earnouts in comparable jurisdictions

The UK, Ireland and Canada each have CGT regimes that are broadly similar to the Australian CGT.⁴⁷ Somewhat lightheartedly, Evans has suggested⁴⁸ that the Australian CGT is based as to one third on the worst features of the UK regime; as to one third on the worst features of the Canadian CGT regime; with the remainder devilishly concocted by Canberra Treasury officials to confuse Australian taxpayers. The Irish cannot be held responsible, but their CGT regime nonetheless broadly mirrors the UK provisions.

Earnouts feature regularly in all three jurisdictions, and the tax treatment for the vendor is relatively well canvassed in the relevant literature for each country. Interestingly, technical sources in all three countries do not refer at all to the CGT treatment of the buyer, suggesting that the buyer’s position is even more settled, to the point that there is no contention about the matter. Presumably, in the case of each of

⁴⁵ Draft Taxation Ruling TR2007/D10, at para 90.

⁴⁶ Joint Submission by The Institute of Chartered Accountants in Australia, CPA Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia on Draft Taxation Ruling TR2007/D10, dated 14 December 2007, at para 45.

⁴⁷ Earnouts also feature prominently in the USA. The taxing provisions, however, are quite different from the Australian CGT, and so are not considered in this paper.

⁴⁸ “From Whitehall to Wagga Wagga: The Legacy of UK Taxation Law in Australia”, M. Walpole and C. Evans, *British Tax Review*, forthcoming.

the three countries, therefore, the buyer is able to account for the acquisition, for tax purposes, within the cost base of the business shares or assets, regardless of the timing and contingency of the payments for the assets.

UK⁴⁹

The UK CGT provisions relating to earnouts operate differently depending upon whether the deferred consideration involved is either capped (in the sense of being ascertainable at the time of the disposal of the original assets) or uncapped (unascertainable), and whether it is received in the form of cash or shares/debentures.

The amounts of the future payments are considered to be ascertainable if, at the time of the disposal of the original assets, they are known; or ascertainable by calculations; or are ascertainable by making up an account and all of the events which establish the amount have occurred by the date of the disposal. Examples of ascertainable future payments are:

- the agreement for the disposal of the asset provides for a consideration of £300,000, of which £100,000 is payable on completion and £200,000 will be payable in four annual instalments of £50,000;
- the agreement for the disposal of a business provides for a consideration of £100,000 and a sum equal to half of the taxable profits of the business for the year ended on the date of disposal payable nine months after the date of the contract.⁵⁰

Payments which are ascertainable but contingent are treated in the same way as all other ascertainable amounts. The wording of the agreement will link the liability to pay the future amount or amounts with the occurrence or non-occurrence of a particular event. Examples of ascertainable but contingent payments are

- the agreement for the sale of a business provides for a consideration of £250,000, of which £200,000 is payable on completion and £50,000 is payable if the profits of the year following the date of disposal exceed £100,000;
- the agreement for the sale of a piece of land provides for a consideration of £75,000, of which £50,000 is payable on completion and £25,000 is payable if planning permission is granted within two years of the date of the disposal.

The defining feature of ascertainable deferred consideration is that all of the events which affect the amount occur before the date of the disposal. The consideration will be unascertainable if events which establish the amount do not occur until after the date of the disposal.⁵¹

Where the consideration is ascertainable deferred cash consideration, then the procedure is straightforward: the consideration is the sum of the initial consideration

⁴⁹ I am grateful to Martin Harris, Senior Manager, Tax at PricewaterhouseCoopers in London for providing me with source material for this section.

⁵⁰ Her Majesty's Revenue and Customs *Capital Gains Manual* at paras CG 14881 and 14882, accessed at <http://www.hmrc.gov.uk/manuals/CG1manual/index.HTM> 11 January 2008.

⁵¹ Her Majesty's Revenue and Customs *Capital Gains Manual* at paras CG 14883 to 14887, accessed at <http://www.hmrc.gov.uk/manuals/CG1manual/index.HTM> 11 January 2008.

plus the capped amount of additional consideration. Those capital proceeds are used in the calculation of the capital gain which is assessed on the vendor in the year of the disposal of the original assets. Should the vendor eventually not receive the full amount of deferred consideration, then the assessment will be amended to reduce the amount assessed to a capital gain based on the actual total consideration received. The vendor may also be able to elect under sec 280 Taxation of Chargeable Gains Act 1992 (TCGA92) to pay the tax in instalments to take into consideration the delay in receiving the full amount of the consideration.

Different CGT consequences ensue where the payments are unascertainable. Examples of unascertainable payments are

- the agreement for the sale of shares in a company provides for an initial payment of £100,000 plus three further payments equal to the excess of the company's profits over £300,000 in each of the three years following the date of the contract;
- the agreement for the sale of land provides for a consideration of a capital sum payable in three annual instalments to be calculated by reference to the tonnage of land fill dumped on that site in the three years after the date of the contract.⁵²

Where the earnout is uncapped (unascertainable), the vendor's consideration is the initial cash sum plus the right to receive a future unascertainable amount. This principle was established in two tax cases: *Marson v Marriage*⁵³ and *Marren v Ingles*.⁵⁴ Both cases concerned agreements for the sale of assets in which the vendor received a quantified amount of money plus a conditional and unquantifiable further amount payable at an unascertained future date. The point in dispute in both cases was whether any chargeable gain arose when the further amounts were received.

In *Marson v Marriage*, Justice Fox held that sec 48 TCGA92 applies when the sum to be brought into account represents ascertainable consideration even when the right to it is contingent. It does not apply when the amount is unascertainable.

Two important principles were established in *Marren v Ingles*:

- the right to receive future unascertainable payments is a “chose in action”. This is an incorporeal asset which is a chargeable asset for CGT purposes; and
- when the future amounts are ascertained and received they are “capital sums derived from assets” within sec 22 TCGA92.

There is therefore a separate chargeable occasion when each instalment of future payment is received. This right is valued at the time of the sale and the total of cash and the value of the future right is assessed on the vendor. As each earnout event occurs a part disposal of the future right occurs and a taxable profit or loss arises on the vendor. Under the old CGT rules this could have a harsh effect on the vendor as it was not possible to carry a capital loss back to an earlier period. However the

⁵² Her Majesty's Revenue and Customs *Capital Gains Manual* at para CG 14888, accessed at <http://www.hmrc.gov.uk/manuals/CG1manual/index.HTM> 11 January 2008.

⁵³ 54 TC 59.

⁵⁴ 54 TC 76.

provisions of sec 279A TCGA92, introduced in 2003, do now permit the vendor to elect to carry back any such loss to the year of the original disposal. There is, however, no possibility of paying the tax by instalments (as is the case with ascertainable cash consideration).

Appendix One contains an example that illustrates the operation of the UK CGT provisions where unascertainable deferred consideration is involved.

If the earnout is in the form of shares or securities, the reorganisation provisions (sec 135 TCGA92 et seq) come into play. From 10 April 2003, unascertainable earn out rights, payable in the form of shares or securities, are automatically treated as part of a scheme of company reconstruction. These provisions will permit a deferral of the capital gain or capital loss until the replacement shares or securities are sold. They are not considered further in this paper.

Ireland⁵⁵

The Irish CGT provisions are broadly similar to those in the UK in that CGT is chargeable on the gains arising from the disposal of assets. Earnouts are relatively frequent in Ireland, but to date such transactions have not been ruled on by the Irish courts. The UK cases⁵⁶ are persuasive but not binding for the Irish courts, and those courts may take a different view if the matter does eventually come before them. In practice, the Revenue Commissioners in Ireland appear to follow the UK approach quite closely, although some local commentators⁵⁷ “hope that an Irish court would adopt a more considered and commercially logical interpretation of sec 563(1)(a) [of The Taxes Consolidation Act 1997 (TCA97), the relevant Irish legislation] and not blindly follow *Marren v Ingles* as the Revenue Commissioners have chosen to do.”

Section 563(1)(a) TCA97 applies where the contingent consideration is in any way capped, and requires the seller to recognise, as sale proceeds at the time of the sale, the maximum amount of earnout consideration that could be payable, without any regard to the fact that the right to receive such consideration is contingent and may never crystallise.

Where part or all of the consideration is deferred and where the amount of the deferred contingent consideration is wholly unascertainable (ie the quantum of the earnout consideration is not capped: it is “wholly uncertain in amount”), sec 563 TCA97 does not apply. In the view of Revenue Commissioners the approach set out in the UK case of *Marren v Ingles* would apply. Hence⁵⁸:

- the value of the earnout at the time of sale would need to be determined and included in the proceeds of sale in calculating the gain;

⁵⁵ I am grateful to Eoghan Gillen and Liam Grimes of KPMG Ireland for providing me with source material for this section.

⁵⁶ Such as *Marren v Ingles* ([1980] 3 All ER 95), but also *Marson v Marriage* (54 TC 59), *Randell v Plum* ([1975] STC 191), and *Coran v Keighley* (48 TC 370).

⁵⁷ W. Fry, *Tax and Legal Considerations when Preparing a Private Company for Sale or Investment*, 23 January 2003, accessed at www.williamfry.ie/article on 28 February 2008.

⁵⁸ W. Fry, *Tax and Legal Considerations when Preparing a Private Company for Sale or Investment*, 23 January 2003, accessed at www.williamfry.ie/article on 28 February 2008.

- a separate asset would exist and would be deemed to have a cost base equal to the value of the earnout determined at the time of sale; and
- each subsequent receipt under the earnout would be deemed to be a part disposal of the notional asset.

The *Marren v Ingles* approach has the effect of pre-imposing tax on gains that may never be realised. It also disadvantages the taxpayer by preventing access to a number of reliefs in respect of the second disposal of the right to receive the contingent future payments. Such concessions that cannot be accessed include roll-over relief and retirement relief.

Like the UK, the Irish legislation provides for a form of bad debt relief (sec 563 TCA97) where consideration for the disposal of an asset proves to be uncollectable or irrecoverable. Also similar to the UK, there are provisions which permit roll-over relief for paper for paper (scrip for scrip) transactions in earnout situations (sec 586 TCA97).

Canada⁵⁹

The Canadian taxing provisions contemplate three possible means of taxing the seller where earnout arrangements are entered into. The first (which is the least frequently used method in practice) bears the closest resemblance to the “separate asset” approach applied by the ATO in Australia. The third – known as the “cost recovery method” – more closely resembles the underlying asset approach.

Normally, when a vendor disposes of a capital asset, the expectation is that a capital gain will be realised equal to the difference between the proceeds of disposition of the asset and its adjusted cost base. In an earnout, Bloom notes⁶⁰ that the Canadian Revenue Agency (CRA) would generally expect the vendor to include in its proceeds of disposition the estimated fair market value (FMV) of the earnout “rights” at the date of disposition. The right to receive earnout amounts in future years would, thus, be treated as consideration received on the disposition of the shares in the current year. The vendor would then account for any amounts subsequently received (or not received) in respect of the earnout rights as follows: each year's earnout rights would be considered a separate capital property having an adjusted cost base (“ACB”) equal to its FMV at the date of disposition of the shares. At the end of each year, that year's earn-out rights would be considered to have been disposed of for proceeds of disposition equal to the amount received or receivable for that year. A capital gain or loss (separate and distinct from the capital gain or loss on the prior disposition of the shares) would result in each year unless the proceeds for that year were equal to the ACB of that year's earn-out rights.

A second approach that can occur in Canada (also rare) is to treat the contingent and unascertainable capital proceeds as being on revenue account, under the provisions of paragraph 12(1)(g) of the *Income Tax Act*. “In general terms, if the provisions of paragraph 12(1)(g) apply, proceeds that would otherwise be characterised as a capital receipt to the vendor, are re-characterised as fully taxable income. The provision

⁵⁹ I am grateful to Felicity Withington, Senior Manager – Tax, KPMG Vancouver for providing me with source material for this section.

⁶⁰ “A Pot Pourri of Issues”, B. Bloom, *Journee d’Etudes Fiscales*, 2003

provides that: “Any amount received by the taxpayer in the year that was dependent on the use of or production from property whether or not that amount was an instalment of the sale price of the property...” is required to be included in computing the vendor's income”.⁶¹

The third Canadian approach – and apparently the method most commonly used in practice – is based upon an administrative interpretation of the Canadian legislation. The CRA's Interpretation Bulletin Number IT 426-R applies specifically to capital gains or losses on the sale of shares subject to an earnout agreement. It notes that the two approaches outlined above can produce unsatisfactory results for both the taxpayer and the CRA, and consequently indicates that the CRA will accept the use of what it calls the “cost recovery method” of reporting the gain or loss on the sale of shares under an earnout agreement where certain conditions are met.

The conditions are not onerous and include:

- taxpayers can only use the cost recovery method where the vendor and purchaser are dealing with each other at arm's length;
- the gain or loss on the sale of shares of the capital stock of a corporation is clearly of a capital nature;
- it is reasonable to assume that the earnout feature relates to underlying goodwill the value of which cannot reasonably be expected to be agreed upon by the vendor and purchaser at the date of the sale; and
- the earnout feature in the sale agreement must end no later than five years after the date of the end of the taxation year of the corporation (whose shares are sold) in which the shares are sold.

Under the cost recovery method, the vendor reduces his adjusted cost base of the shares as amounts on account of the sale price become determinable. Once such an amount on account of the sale price exceeds the adjusted cost base of the shares (as reduced by any previous such amounts), the excess is considered to be a capital gain that is realised at the time that that amount became determinable (ie it is capable of being calculated with certainty and the taxpayer has an absolute but not necessarily immediate right to be paid), and the adjusted cost base becomes nil. All such amounts that subsequently become determinable are treated as capital gains at the subsequent time.

In summary therefore, both the UK and Ireland apply the separate asset approach to vendors to deal with the unascertainable and contingent deferred consideration in earnouts. But – and this is important – both recognise the potentially harsh CGT consequences for vendors, and mitigate those implications by providing various forms of capital loss carry back provisions and by permitting “look-back” such that original CGT computations can be amended to reflect the ultimate reality of the transaction. In Canada a separate asset approach is also applicable on a strict legal reading of the provisions, but in practice a more sensible and practical underlying asset approach – in the form of the cost recovery method – is generally adopted. For purchasers, the

⁶¹ “Selected Aspects of the Purchase and Sale of a Business”, J.H. Berliner, 2006 *Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 2006) 10:1-25.

acquisition costs (both initial sums paid and unascertainable amounts payable) simply find their way into the cost base of the assets.

Future directions

In 1999 the Review of Business Taxation noted that “a well-functioning taxation system...should provide certainty...”.⁶² Taxpayers, and more significantly in this case, tax practitioners, crave certainty. Unfortunately Draft Taxation Ruling TR2007/D10 does not provide it for those seeking to understand the tax implications for vendors and purchasers in situations commonly referred to as earnouts.

This paper has highlighted a number of uncertainties that derive from the draft ruling as it currently stands. It has been noted that the “recent release of Draft Taxation Ruling TR2007/D10 has only created more confusion for advisers providing tax advice in this area.”⁶³ The Professional Bodies concur, suggesting that “the application of the separate asset approach to both the buyer and the seller in standard and reverse earnout arrangements will result in inappropriate economic outcomes for taxpayers and for the revenue in a number of circumstances, and would lead to major practical compliance issues”.⁶⁴

Moreover, those seeking guidance from the ATO are left in a strange state of limbo as a result of the withdrawal of the old ruling (TR93/15) on the same day as the draft ruling, which does not cover all of the ground addressed by the withdrawn ruling, was issued. Hence TR93/15 no longer applies but the “replacement” is only a draft. And as the caveat printed on draft rulings makes clear, it represents only the Commissioner’s preliminary view. While the draft can protect the taxpayer from interest and penalties, it affords no protection from increased tax liability if the ATO subsequently modifies its views.

Apart from leaving taxpayers in limbo, other uncertainties or problematic issues (many noted in the paper to date) include:

- the increased compliance costs problem for vendors if valuations have to be obtained where rights are a single asset (the ATO’s preferred position);
- the possibility of stranded capital losses for vendors where initial valuations of the earnout right exceed payments subsequently received in respect of the right;
- the potential denial of reliefs and concessions to the vendor as a result of the two stage separate asset approach. Losing grandfathered status and the CGT discount can happen but is likely to be relatively rare; far more problematic is the denial of access to the small business concessions where capital gains arise from CGT events relating to the newly created earnout right; and the potential

⁶² *A Tax System Redesigned*, Review of Business Taxation, Report July 1999, Canberra. Indeed the “sub-title” of the report was “More **Certain**, Equitable and Durable”.

⁶³ S. Kotsopolous, “Earnout Chaos for M & A Tax Advisers”, *CCH Tax Week*, Issue 47, 29 November 2007.

⁶⁴ Joint Submission by The Institute of Chartered Accountants in Australia, CPA Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia on Draft Taxation Ruling TR2007/D10, dated 14 December 2007, at para 5.

loss of scrip for scrip relief. This would appear to be at odds with the underlying policy rationale behind the small business and scrip for scrip concessions;

- the requirement that the vendor pay tax upfront on the market value of the earnout right; and the vendor will not be entitled to any interest if tax is subsequently determined to have been overpaid by the vendor (eg as a result of the earnout right lapsing);
- the uncertainties that exist for the purchaser in determining the CGT implications where there is a variation between the market value of the earnout right and actual amounts paid under that right: will other CGT provisions operate to produce a capital gain or loss, or do the general deduction provisions, the blackhole expenditure provisions, the debt forgiveness rules, or even the Taxation of Financial Arrangements (TOFA) rules, come into play?⁶⁵
- the uncertainty that exists for the purchaser in respect of the potential application of CGT event D1 when the purchaser creates contractual rights in the vendor to receive additional amounts depending upon business performance.

There are also other problems and uncertainties not considered in the paper. For example, the draft ruling raises important issues relating to tax consolidation, and there are concerns that the application of the interpretative approach suggested in the draft ruling may lead to significant revenue leakage. Moreover, many of the uncertainties and problems raised in the paper are compounded in the case of reverse earnouts, which have not been specifically considered in this paper.

To be fair, some of the problems that have been raised in this paper are not new. For example, the approach taken by the ATO in TR93/15 also brought about the possibility of stranded capital losses for the vendor.

Solutions are possible. Specific problems can be tackled by way of legislative amendment. For example, the problem of stranded losses could be dealt with, as is the case in the UK, by a provision that permits the carry back of capital losses in circumstances where a series of CGT events broadly related to the same transaction or continuum of transactions give rise to both gains and losses. Alternatively, and assuming earnouts take place over a relatively short timeframe (say up to four years), amendments to original CGT computations to take into account later transactions might be considered.

But such solutions only tinker at the margin of the problems and uncertainties, and may have knock-on implications elsewhere. For example, a loss carry back provision restricted to earnouts may cause future taxpayer behaviour to be reshaped to use (or

⁶⁵ The proposed rules contained within the TOFA Exposure Draft (3 and 4) legislation released in January 2007 suggest an exclusion for earnouts (sec 230-315(13)). But, as noted by the Minerals Council of Australia (*Taxation of Financial Arrangements (3 & 4) – Response to Exposure Draft Legislation, Explanatory Memorandum and Interactional and Consequential Amendments*, Mineral Council of Australia, March 2007), the exclusion would operate on a highly restricted basis. For example, it would not apply to business sales effected by way of shares with an earn-out. Moreover the requirement that the earnout should be contingent upon the economic performance of the business would exclude many earnouts where the variable was not business performance related, as where the value of the earnout payment was based upon the market price of a relevant commodity on a future date.

abuse) this particular earnout concession. A more fundamental reappraisal of approach is probably called for.

One of the principal conceptual flaws in the approach to the taxation of earnouts adopted by the ATO in the draft ruling is its insistence that there should be symmetry in the positions of vendor and purchaser. This desire for symmetry is the root cause of many of the uncertainties that arise, and its abandonment as a guiding principle could go some way to providing for an approach that provided greater certainty.

There is no fundamental reason why the tax treatment of the buyer and seller should be symmetrical. Contrast, for example, the revenue treatment of the payments by a wholesale petrol distributor to induce retailers to enter into trade tie agreements (*BP Australia Ltd v FCT* (1965) 112 CLR 386) with the capital treatment of a corresponding receipt in the hands of the retailers (*Dickenson v FCT* (1958) 98 CLR 460).

Moreover, the ATO has specifically eschewed such symmetry in the past. In (the now withdrawn) TR93/15 it noted⁶⁶ that:

“There is concern over the lack of symmetry between the seller's and the buyer's capital gains tax position in that the seller is taken to have received money and property as consideration while the buyer is taken to have paid only money as consideration. It is not a prerequisite to the operation of the capital gains tax provisions that there be symmetry of treatment between different taxpayers. The provisions must operate according to the particular taxpayer's circumstances and perspective.”

This approach is implicitly abandoned in the draft ruling, and the ATO imposes what might be termed a hybrid symmetry on the buyer and seller.

Rather than seeking to impose an artificial approximation of symmetry on the two ends of the transaction, the ATO might find that more certain outcomes are achieved by adopting the look-through or underlying asset approach that is considered, but rejected, in the draft ruling.⁶⁷ The Professional Bodies also argue that the “look-through approach is the preferred solution for the matrix of potential outcomes that can arise under a standard or reverse earnout arrangement”.⁶⁸

Adopting an underlying asset approach to earnout transactions would lead to more certain outcomes, and less complex calculations, than is currently the case. It would not always work to the advantage of the taxpayer – there would be occasions when the CGT charge would crystallize earlier than is currently the case for the seller. It might also be necessary to combine such an approach with mechanisms to provide for an initial provisional calculation of the gain (based, as at present, on capital proceeds comprising a fixed amount plus a valuation of the future right to receive), followed by confirmation of the gain as and when contingent amounts were ascertained and

⁶⁶ Taxation Ruling TR93/15, at para 11.

⁶⁷ Draft Taxation Ruling TR2007/D10, at paras 83-90.

⁶⁸ Joint Submission by The Institute of Chartered Accountants in Australia, CPA Australia, National Institute of Accountants, The Taxation Institute of Australia and Taxpayers Australia on Draft Taxation Ruling TR2007/D10, dated 14 December 2007, at para 8.

received. Such an amendment mechanism might be combined with a restriction (say four years) on the earnout period for such treatment to apply.

More radically, the Canadian “cost recovery method” – whereby the initial and subsequent receipts of the vendor are progressively applied against the original asset’s cost base, before crystallizing a gain once the cost base is exhausted⁶⁹ – represents a practical application of the underlying asset approach that could sensibly be adopted in Australia.

The underlying asset approach also provides a more than acceptable outcome for the appropriate CGT treatment of the purchaser. Quite simply, the various payments cumulate (as legally incurred) in the cost base of the asset (business or shares) acquired.

In essence, the issues involved in earnouts do not principally relate to the hard tax questions of characterisation. They are primarily issues of timing, and as such an approach which relies upon only one underlying transaction for buyer and seller might prove more workable than one which slavishly follows the consequences of an events based approach and seeks to impose taxing points on a host of artificially contrived happenings.

This is too important an area, with too many knock-on effects elsewhere, for the ATO’s proposed approach in TR2007/D10 to prevail. The words of Warner J in *Zim Properties* should not be ignored:

*...the interpretation of the capital gains tax legislation requires, as does the interpretation of any legislation, the exercise of common sense, rather than just the brute application of verbal formulae.*⁷⁰

⁶⁹ Along the lines of CGT event E4.

⁷⁰ *Zim Properties v Procter* 58 TC 371 accessed on 12 January 2008 at:

<http://info.library.unsw.edu.au/cgi-bin/local/access/access.cgi?url=http://www.lexis.com/au>.

Appendix One: Example illustrating the operation of the UK CGT provisions where unascertainable deferred consideration is involved⁷¹

The vendor acquired the asset (goodwill) in April 1983 for £100,000. The vendor sells the asset at arm's length to the purchaser on 30 April 1991. The consideration is

- cash £500,000, plus
- the right to two payments of deferred consideration in cash, the amount depending on the profits of the business for the next two years.

The market value of the right to deferred consideration at the time of disposal is agreed at £300,000. In September 1992 the vendor receives £220,000 in part satisfaction of the right to deferred consideration. The market value of the remainder of the right is agreed at £90,000. In October 1993 the vendor receives £150,000 in full satisfaction of the remainder of the right to deferred consideration.

COMPUTATION

A: IMMEDIATE CHARGEABLE GAIN (1991-92)			
Consideration received cash (500,000) plus value of right (300,000)			£ 800,000
LESS	Cost		£ 100,000
	Unindexed gain		£ 700,000
LESS	Indexation $100,000 \times 0.579$		£ 57,900
	CHARGEABLE GAIN	1991-92	£ 642,100
B: WHEN DEFERRED CONSIDERATION RECEIVED			
September 1992			
	Consideration		£ 220,000
Less	Apportioned cost	$300,000 \times \frac{220,000}{(220,000 + 90,000)}$	£ 212,903
	Unindexed gain		£ 7,097
LESS	Indexation	$212,903 \times 0.047$	£ 10,006
	ALLOWABLE LOSS	1992-1993	£ (2,910)
October 1993			
	Consideration		£ 150,000
LESS	Cost	$300,000 - 212,903$	£ 87,097
	Unindexed gain		£ 62,903

⁷¹ Her Majesty's Revenue and Customs *Capital Gains Manual* at para CG 14980, accessed at <http://www.hmrc.gov.uk/manuals/CG1manual/index.HTM> 11 January 2008.

LESS	Indexation	87,097 x 0.065	£ 5,661
	CHARGEABLE GAIN 1993-1994		£57,242

