TAX TALKS

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49 | Earnout Arrangements

Earnout arrangements are quite common within the professional services industry. When you buy or sell an accounting or tax practice, you will often sign an earnout arrangement. Not for the entire sale, but for some part of the purchase price.

Earnout Arrangements

Earnout arrangements solve a commercial problem when vendors and purchasers don't agree on the value of the business in question. There are two fundamentally different ways to treat an earnout right for tax purposes. The Separate Asset approach v the "Look Through Earnout Right" (LTER) approach.

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Separate Asset Approach

Before the 24 April 2015, so before the 2015 bill introduced new legislation, the separate asset approach applied as per TR 2007/D10 to all earnout arrangements. There was no "tracing" and no small business CGT concession available for these rights. There was a deemed immediate "disposal" of the right with no ability to amend.

This resulted in a lot of uncertainty regarding the value and tax treatment of earnout arrangements.

The TR 2007/D10 issued on 17 October 2007 included a valuation of the earnout potentially payable in future tax years in the capital proceeds. And the taxpayer included this value in their tax return upon the sale of the business.

Look Through Earnout Right

All this changed with effect from 24 April 20015. The new legislation (Tax and Superannuation Laws Amendment (2015 Measure No. 6) Bill 2015) adopted the look through approach for certain arrangements. It is now possible to "trace" the earnout to the sale of the business itself. This preserves the small business CGT concession and ability to amend tax return to reverse "disposal" of the right.

However, this new approach only applies to arrangements that qualify as a look through earnout right (LTER) per subdivision 118-565 ITAA97.

What is an LTER

Not every earnout arrangement is a look-through earnout right (LTER). It is only an LTER if it meets the following requirements.

1) CGT Event A1

The sale transaction involves CGT event A1.

2) Active Asset

The right must be in connection with the disposal of an active CGT Asset of the seller. The relevant CGT asset must be an active asset of the business before the sale. This includes a share or interest in a trust satisfying the active asset test in section 152-40(3). This is the so-called 80% test.

3) Contingent

The LTER is a right to future financial benefits which are not reasonably ascertainable at the time the right is created. The financial benefits under the right must be contingent on and reasonably related to the future economic performance of the asset (or a related business).

For a right to be a look-through earnout right, the value of the earnout right must depend on the future economic performance of the asset or business. It must be not reasonably possible to ascertain this value at the time of sale.

4) Time Limit

The time limit is 5 years. The right must not require financial benefits to be provided more than five years after the end of the income year in which the relevant CGT event occurs (subs 118-565 (1)(e)).

5) Arm’s Length

The LTER was entered into on an arm’s-length basis.

Tax Treatment

If the earnout arrangement does not qualify as an LTER, the original separate asset approach still applies. If the arrangement qualifies as an LTER, then the look through approach applies.

With this look through approach, you disregard capital gains and losses arising in respect of look-through earnout rights to start with. Instead, you account for these at the time of payment under the earnout arrangement.

The financial benefits provided or received under the earnout right go into the capital gains calculation for the underlying asset. The seller includes the benefits received in the capital proceeds for the disposal of the underlying asset. And the buyer includes the benefits provided in the cost base or reduced cost base of the underlying asset.

There is an adjustment of the rules around amendments periods, interest charges, recognition of capital lossess and access to CGT (and other) concessions. The aim is to ensure that taxpayers receive outcomes broadly consistent with those had they known the value of all financial benefits under the earnout right at the time of the relevant CGT event.

Ending a Look Through Earnout Right

A right is also an LTER if it is a right to receive financial benefits in exchange for ending a n LTER under the general rules (s 118-560 and s 118-565).

Summary

So in summary, the benefits of having an LTER are:

Disregard any capital gain when creating the LTER until time of payment
Cost base to buyer is adjusted by any additional amount paid
Capital proceeds to seller is adjusted by any additional amount received
Period of review extended to allow amendment of returns
Able to remake any election under CGT provisions
Interaction with small business CGT concessions
Capital loss integrity rule

Here is a copy of s118-565 as it stands on 21 June 2018:

INCOME TAX ASSESSMENT ACT 1997 – SECT 118.565

Look-through earnout rights

Look-through earnout rights–main case

1 A look-through earnout right is a right for which the following conditions are met

(a) the right is a right to future * financial benefits that are not reasonably ascertainable at the time the right is created

(b) the right is created under an * arrangement that involves the * disposal of a * CGT asset

(c) the disposal causes * CGT event A1 to happen

(d) just before the CGT event, the CGT asset was an * active asset of the entity who disposed of the asset;
Note: For extra ways to be an active asset, see section 118-570.

(e) all of the financial benefits that can be provided under the right are to be provided over a period ending no later than 5 years after the end of the income year in which the CGT event happens;

(f) those financial benefits are contingent on the economic performance of:

(i) the CGT asset; or

(ii) a business for which it is reasonably expected that the CGT asset will be an active asset for the period to which those financial benefits relate;

(g) the value of those financial benefits reasonably relates to that economic performance;

(h) the parties to the arrangement deal with each other at * arm’s length in making the arrangement.

Matters affecting the 5-year maximum period

2 The condition in paragraph (1)(e) is not met, and is treated as never having been met, for the right if:

(a) the * arrangement includes an option to extend or renew the arrangement; or

(b) the parties to the arrangement vary the arrangement; or

(c) those parties enter into another arrangement over the * CGT asset or a business for which it is reasonably expected that the CGT asset will be an * active asset so that a party could, or does, provide * financial benefits under the right (or one or more equivalent rights) over a total period ending later than 5 years after the end of the income year in which the * CGT event happens.

3 For the purposes of paragraph (1)(e) or subsection (2), in working out the period over which * financial benefits under a right can be provided, disregard any part of an *arrangement that allows for an entity to defer providing such a financial benefit if:

(a) the deferral is contingent on an event happening that is beyond the control of the parties to the arrangement ; and

(b) the deferral cannot change the amount of any financial benefit provided, or to be provided, under the right; and

(c) when the arrangement is entered into, the contingent event is not reasonably expected to happen.

Look-through earnout rights–rights for ending other rights

4 A look-through earnout right is a right to receive one or more future * financial benefits that:

(a) are for ending a right to which subsection (1) applies; and

(b) are certain.

Note: This subsection will not apply if the old right ends as described in subsection (2), as subsection (2) causes the old right to be treated as if it had never been a right to which subsection (1) applies.

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