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25 May 2015

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Dear Sir / Ms

CGT TREATMENT OF EARNOUT ARRANGEMENTS

We appreciate being given the opportunity to comment on the Exposure Draft legislation [‘the ED’] and the Exposure Draft explanatory memorandum [‘the EM’] on the CGT treatment of earnout arrangements.

Pitcher Partners is one of the largest accounting associations in Australia outside the Big Four and comprises 6 independent firms operating in Adelaide, Brisbane, Melbourne, Newcastle, Perth and Sydney. Our specialisation is advising smaller public companies, large family businesses and small to medium enterprises - which we refer to as the “middle market” or “SMEs” in this submission.

In its current form, we do not support the introduction of the ED as final legislation. We believe that the ED fails to achieve any of the objectives of the current Government with respect to middle market taxpayers.

We are surprised that Treasury would seek to introduce legislation that is both extremely complex and uncertain, especially in light of the findings of the Board of Taxation on small business in 2014 and the Government’s objective for reducing red tape.

The proposed legislation will take what should be a very simple set of rules to an extreme where expert advice will be required on multiple aspects - including complex definitional aspects of the CGT small business concessions. The latter is even more surprising to us, given that the Board of Taxation only recently outlined

the complexities of the small business concessions in their report to the Assistant Treasurer – yet the new law will seek to increase reliance on those very complex definitions (such as CGT concession stakeholders).

We are unclear why simpler options (such as the earnout definition in TR 93/15 or the business earnout definition in the TOFA rules) have not been used. In our view, the latter option (i.e. the definition of an earnout in the TOFA provisions), which was specifically drafted in anticipation of these new provisions, would have been the logical choice.

We also highlight that the transitional provisions are not sufficient to deal with the majority of taxpayers that have operated in an appropriate way during an 8 year period of uncertainty. Again, it will be unacceptable if this aspect is not addressed given that taxpayers have acted in good faith in awaiting legislation to be released.

It is therefore our view that any final legislation needs to have a prospective application date, being the date of Royal Assent. This is consistent with the public announcements to date.

We have attached our detailed comments in a number of Appendices to this letter. We would be happy to discuss these issues with you. However, to the extent that these issues cannot be addressed we highlight that we do not support the introduction of these measures. For completeness, as our concerns are significant on these matters, we have provided a copy of this submission to both the Board of Taxation and to the Minister for Small Business.

Further information

Please contact the writer on 03 8610 5170 if you would like more information on, or clarification of, any of the issues raised in this submission.

Yours faithfully



AM KOKKINOS
Executive Director

Encl: Appendices

Appendix 1 - Complexity of the drafting in the exposure draft ['ED']

Definition of an earnout arrangement

On 20 January 2015 the Government responded to a report issued by the Board of Taxation ['the Board'] titled "Review of tax impediments facing small business". In this report the Board identified and recommended:

... key reform priorities that aim to reduce tax impediments facing small business. Many of the reforms are also intended to reduce compliance costs and foster an environment in which more people are encouraged to take up business opportunities.

The approach taken in the ED regarding earnouts, which are widely used by the middle market, is inconsistent with this objective of reducing compliance costs and fostering an environment in which people are encouraged to take up business opportunities. This is, by far, one of the most complex pieces of legislation that has been released relating to small business in a number of years.

Based on our experiences with middle market taxpayers, if the ED and EM are finalised in their current form, taxpayers will not readily understand whether an earnout will apply in any given case - requiring costly and detailed advice and calculations to be performed.

Before the release by Treasury in 2010 of its earlier Discussion Paper ['the Paper'] on earnouts, TR 93/15 and draft TR 2007/D10 provided the relevant guidance on the capital gains tax treatment of earnout arrangements. The definitions of an earnout that were used in both rulings were easy to understand and apply.

For example, TR 93/15 described an earnout as:

... the sale of an asset for a lump sum plus a right to a contingent and unascertainable amount. An amount is contingent if the event giving rise to its payment may or may not occur, and unascertainable if it can be calculated only when the event occurs.

TR 2007/D10, in turn, simply defined an earnout right as:

... 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).

The Paper similarly, had a simple definition of an earnout right:

Earnout arrangements are a common and efficient way of structuring the sale of an asset to deal with uncertainty about the value of the asset, for example the goodwill attached to a business. The proceeds for the sale of the business (or assets of the business) typically include a lump sum payment plus a right to further payments that are contingent on the performance of the business - an 'earnout right'.

These simple definitions can be contrasted with the definitions used in the ED - which, as our comments below show, we have found to be very complex and not easy to understand.

In our opinion, the existing definition of an earnout in subsection 230-460(13) of the 1997 Tax Act should be used as the base definition of an earnout. This definition is very simple, easy to understand and in our view requires only minor modifications to produce an appropriate outcome. It is also drafted in a “principles based” manner and thus would allow the ATO some ‘wriggle room’ in relation to interpreting when the provision will apply (and not apply). Here is subsection 230-460(13):

*A right to receive, or an obligation to provide, *financial benefits arising from the sale of:*

(a) a business; or

(b) shares in a company that operates a business; or

(c) interests in a trust that operates a business;

is the subject of an exception if the amounts, or the values, of those benefits are contingent only on the economic performance of the business after the sale.

In our view, this alternative definition meets the objectives of limiting the provision to a “business sale” and provides some flexibility for ATO administration and interpretation going forward. Given that the EM to subsection 230-460(13) specifically stated that this definition was intended to work with the new earnout provisions, we are surprised that this definition was ignored during the drafting process.

We also note that the approach taken in the ED is not only vastly different to prior announcements in 2010 but there is also no explanation in the EM of the reasons behind this change.

The definition of a look-through earnout right

The definition of a look-through earnout right [‘LTER’] in section 118-565 is very complex, far from intuitive and will require taxpayers and their advisers to have a thorough understanding of all of the tests. In particular, the following is not clear.

- We do not quite understand how the definition will be applied in the sale of a business comprising multiple assets - especially where some of those assets are not regarded as CGT assets [for example, information] and other assets are not active assets. We are not clear as to whether a taxpayer will be forced to dissect an agreement for the sale of a business and apply the LTER definition to each asset.
- In light of the fact that the CGT small business concessions dealing with the disposal of active assets cover all CGT events apart from CGT event K7, we are unsure why a LTER is limited to a disposal that causes CGT event A1 to happen.
- In the case of companies and trusts, a LTER is restricted to the disposal of interests in an Australian resident company or a resident trust for CGT purposes. We do not understand why such a restriction would be imposed,

especially if a business has interests in foreign entities which could be sold as part of the whole package of entities under a LTER.

- It is not clear as to the criteria that a vendor will be required to meet before it can satisfy the test that it is “reasonably expected” that a purchaser will use a CGT asset as an active asset over the period of the LTER.
- Further, it is uncertain whether a mere agreement to extend the time for making a payment under an arrangement will cause subsection 118-565(2)(b) to be failed¹

Section 118-570 – reliance on small business concession terms

We cannot emphasise enough the difficulties that will arise under section 118-570 from requiring a taxpayer to determine (at the relevant time) whether certain small business concession tests are satisfied. That is, whether there is a CGT concession stakeholder in a company or trust or an entity has a small business participation percentage in a company or trust of 20%.

These concepts from the CGT small business concessions are not only totally foreign to many taxpayers and their advisors but they are very complex to apply, even for those that work regularly in this area.

As the Board stated in its report “Review of tax impediments facing small business” mentioned above:

... the rules governing eligibility for the small business CGT concessions are exceedingly complex and difficult for small businesses to navigate.

... significant concerns [were] raised by stakeholders about the complexity and compliance costs of the concessions.

... the Board considers a ... fundamental review of the Small Business CGT concessions is warranted given the potential for significant simplification and reduction in compliance costs.

We are therefore very surprised that Treasury would ignore these findings and would then extend the use of these terms for other provisions. We are significantly concerned with this approach.

The cost base and capital proceeds adjustment rules

We query whether the drafting of the cost base and capital proceeds adjustment rules needs to be as complex as that contained in the ED. For example, it is queried whether the provisions only need to: (a) exclude an earnout from being a CGT asset; (b) make it clear that a capital gain does not arise on an earnout; (c) ensure that an earnout is not included in the cost base or capital proceeds of an underlying asset; and (d) ensure that the amounts received or paid when closing out the earnout are included appropriately.

¹ We assume not from comments in the EM but absent a Note to this effect in the legislation it is not as clear-cut as it should be.

We also note that absent any explanation or justification in the EM as to why the 'new CGT event' / 'cost base reduction' approach advocated in the Paper has been abandoned, we are unable to comment on whether the complexity that will arise under the 'amendment approach' in the ED is any greater or less than would have arisen if the former approach had been pursued.

We highlight that the need to: amend prior year returns; adjust capital proceeds and cost bases; and deal with capital losses etc under the 'amendment approach' is going to be very complex.

At a high level, we believe that the 'cost base reduction model' would seem to achieve the same CGT outcomes. In our view, especially in the absence of any justification in the EM for the abandonment of this model, we do not accept that there would be significant difficulties in incorporating this model into the small business concessions. For example, it could be possible to avoid interaction issues with the CGT small business concessions by linking the testing time for accessing these concessions back to the date of the original [underlying] CGT event.

Appendix 2 - Transitional provisions

While we welcome the fact that transitional protection will be provided to taxpayers [by a proposed amendment to how section 170B of the 1936 Tax Act covering announced but unenacted measures will be applied], we are concerned that the proposed measure will not provide protection to the vast majority of taxpayers who have acted in good faith during the 8 years of uncertainty since TR 2007/D10 was released.

As a starting point, we highlight that the protection in the announcement is restricted to.

Budget Paper No. 2, Budget Measures 2011-12, Part 1, topic headed "Capital gains tax - look-through treatment for earnout arrangements"

However, the above Budget Paper merely states [emphasis added] that the:

... Government will allow all payments under a qualifying earnout arrangement to be treated as relating to the underlying business asset. The measure will have effect from the date of Royal Assent of the enabling legislation, with transitional provisions available in certain cases from 17 October 2007.

The Treasury Paper on the other hand not only states that:

... the buyer in a standard earnout arrangement will have the choice to apply look-through treatment for arrangements entered into on or after 17 October 2007,

but goes on to say [emphasis added] that for:

... arrangements entered into before this date they have the choice to rely on Tax Ruling 93/15 (which effectively provides look-through treatment by allowing payments made under an earnout arrangement to be included in the buyer's cost base).

In our view, as the Treasury Paper specifically advocated that taxpayers could rely on TR 93/15, the transitional relief that is provided in the final legislation should cover taxpayers who have acted on the basis of: TR 93/15; TR 2007/D10; or the approach taken in the Paper - i.e. the transitional relief should not be restricted to taxpayers who have entered into earnout arrangements after 17 October 2007.

Furthermore, as the Treasury Paper made reference to 5 years as being a potentially acceptable period of time for an earnout arrangement (see Section 3.3, dot point 1), we believe it would be unfortunate if the transitional rules did not respect the TR 93/15 approach or arrangements having a period of 5 years.

We highlight that this is not a theoretical issue. We are aware of taxpayers that have acted in good faith and relied on these documents in preparing their tax returns. It would be extremely unfortunate and disappointing if the final legislation penalised these taxpayers due to the legislation taking some 8 years to be implemented. We would strongly recommend that this issue be addressed in the final legislation.

Appendix 3 - Prospective application date

We believe that consistent with the previous announcements by the [then] Government and Treasury in 2010, the proposed amendments should only apply for earnout arrangements entered into after the date of Royal Assent.

In this regard, a prospective application date from the day of Royal Assent would also align with what the ATO has stated on its website for a number of years. Here is what the ATO said on its website on 11 September 2013 regarding its Administrative Treatment for earnouts:

Administrative treatment

This measure will take effect on the day of royal assent. However, the following transitional arrangements will be available:

- 1. Taxpayers will have the choice to apply the proposed look-through treatment for earnout arrangements entered into between 12 May 2010 and the date of royal assent (inclusive).*
- 2. In addition, the buyer in a standard earnout arrangement will have the choice to apply the proposed look-through treatment for earnout arrangements entered into on or after 17 October 2007.*

We will accept returns as lodged during the period up until the amending law is enacted. We will not review assessments until the outcome of the proposed amendment is known.

If a taxpayer chooses to apply the first transitional arrangement explained above and the amending law is enacted, no further action is required. If the amending law is not enacted, taxpayers will need to review their positions and seek amendments accordingly.

Taxpayers who wish to apply the second transitional arrangement should review their positions once the amending law is enacted and then seek amendments to take advantage of the transitional arrangement. If the amendment reduces the amount of tax they are liable to pay, they will be entitled to interest on any overpayments.

In both cases, we will not apply any tax shortfall penalties and we will remit any interest accrued at the base interest rate up to the date the amending law was enacted. We will remit any interest that accrues in excess of the base rate after that date if taxpayers actively seek to amend their assessments within a reasonable timeframe. [ATO webpage on 11/9/13]

We also highlight that in practice [notwithstanding the release of the ED and subsequent amending legislation] middle market taxpayers and their advisers will only become aware of the new CGT treatment of earnouts when the legislation has been finalised and passed through Parliament. That is, very few (if any) small to medium sized businesses and their advisers would be considering and reviewing exposure draft legislation when looking at potential commercial transactions.

Accordingly, given the uncertainty and the problems with the ED (as highlighted in this submission), we do not think it would be appropriate to have an application date that is earlier than Royal Assent.

Appendix 4 - Interaction with the CGT scrip for scrip and tax consolidation rules

Interaction with the CGT scrip for scrip rules

As the proposed definition of a LTER uses the existing definition of a ‘financial benefit’ in section 974-160 [which includes property, such as shares] we understand that it is intended that where the original shares in a company are disposed of in exchange for: (i) a fixed number of replacement shares; and (ii) an additional number of replacement shares depending on future economic performance, then such an arrangement can be a LTER.

It is difficult (however) to be certain on this conclusion on the current wording of the ED. Given that this issue has previously been raised in the NTLG and has been raised with Treasury on multiple occasions, this issue cannot be ignored in finalising this legislation.

We request therefore, that there be guidance and an example in the EM covering the operation of the earnout rules to a scrip for scrip based arrangement and that the EM confirm that the additional shares received can qualify as a LTER.

Interaction with the tax consolidation rules

The EM suggests that the tax consolidation provisions would automatically correct themselves with the proposed amendments. However, on the current drafting, we do not believe that the provisions operate this way.

That is, section 705-65(5B) requires money to be paid or property given with respect to the acquisition of the relevant asset. The deeming rules contained in proposed section 112-36 do not deem there to be either of these things. That is, paragraph (1)(b) simply includes an additional amount in the first element.

If section 112-36 instead deemed there to be an amount paid or property given, we would agree with the conclusion of Treasury in the EM. Furthermore, if this section replaced the cost base of the asset, we would agree that section 112-15 would also operate in the manner outlined by Treasury. However, section 705-65(5B) is very specific in that it does not include “the first element”, it includes amounts paid or provided by way of cash or property.

Accordingly, we request Treasury to clearly articulate how the provisions operate to achieve the outcome in the EM. If this cannot be done, we request that section 705-65(5B) be amended to specifically include amounts that would otherwise be included in the first element of the cost base of the shares (rather than amounts paid or provided by way of cash or property). We believe that this latter request is a very basic change to section 705-65(5B) that would address our concerns.