Australian Government

The Board of Taxation

REVIEW OF THE INCOME TAX TREATMENT OF CERTAIN FORMS OF DEFERRED CONSIDERATION

the board of taxation

www.taxboard.gov.au

A POST-IMPLEMENTATION REVIEW OF SUBDIVISION 118-I OF THE INCOME TAX ASSESSMENT ACT 1997

September 2018

Manager
Media and Speeches Unit
The Treasury
Langton Crescent
Parkes ACT 2600
Email: medialiaison@treasury.gov.au

CONTENTS

FOREWORD

The Board of Taxation (the Board) is pleased to submit this report to the Treasurer, the Hon Josh Frydenberg MP, following its self-initiated post-implementation review of the capital gains tax (CGT) look-through provisions for eligible earnout arrangements contained in Subdivision 118-I of Part 3-1 of Chapter 3 the *Income Tax Assessment Act 1997* (Act).

The Board has made a number of recommendations to seek to increase certainty for taxpayers regarding the operation of the CGT look-through provisions.

In response to feedback received during consultation regarding the increasing prevalence of deferred consideration arrangements, the Board has also investigated the operation of the Act in respect of deferred consideration arrangements that do not fall within the scope of the CGT look-through provisions and has identified some areas of concern which the Board believes warrant Government attention. This report's title reflects the broader scope of the Board's review based on this feedback.

The Board established a Working Group to undertake the review. Board members comprising Mrs Ann-Maree Wolff (Chair), Mr Craig Yaxley and Dr Mark Pizzacalla were appointed to oversee this review.

The Working Group also included the members of the Board's Advisory Panel, namely, Mr Hayden Scott (PwC), Mr Anthony Portas (Minter Ellison), Mr Andrew Noolan (Brown Wright Stein Lawyers), Mr Andrew Van Dinter (Ernst & Young) and Mr Cameron Rider (Greenwoods & Herbert Smith Freehills Pty Limited), as well as officials from the Department of the Treasury and the Australian Taxation Office (ATO).

The Working Group conducted several open, round-table consultation sessions and a number of targeted consultations to seek stakeholder feedback during the course of the review.

The Board would like to thank the members of the Board's Advisory Panel, officials from the Department of Treasury and the ATO, and all those who participated in consultation sessions, for their valuable assistance during the course of this review.

The ex officio members of the Board – the Secretary of the Treasury, Philip Gaetjens, the Commissioner of Taxation, Chris Jordan AO, and the First Parliamentary Counsel, Peter Quiggin PSM – have reserved their final views on the recommendations for advice to Government.

Michael Andrew AO
Chair, Board of Taxation

Ann-Maree Wolff
Board Member
Chair of the Board's Working Group

EXECUTIVE SUMMARY AND RECOMMENDATIONS

On 26 May 2017, the Board resolved to undertake a self-initiated post-implementation review of Subdivision 118-I of Part 3-1 of Chapter 3 the *Income Tax Assessment Act 1997* – the CGT look-though provisions.

The Board has prepared this report as the product of its post-implementation review and further analysis of the income tax treatment of certain forms of deferred consideration arrangements. Information on the Board's review process and consultation is provided at Appendix A.

As an overarching observation, this review has highlighted that significant difficulties arise where the provisions of the tax law fail to align tax consequences with the economic or commercial outcomes of transactions. The difficulties explored in this report provide a telling practical example of this potentially more systemic concern where corporate income tax outcomes do not ultimately reconcile with the profit or loss of firms.

While this executive summary outlines the Board's findings in a number of key areas of tax policy and administration, the Board considers that most issues on which the Board has recommended further guidance or reform ultimately stem from difficulties where law and practice depart from this core premise.

Misalignment between tax and economic outcomes: deferred consideration arrangements

The Board has become aware of an emerging trend in the market regarding deferred consideration arrangements where the application of the current law results in anomalies and in the Board's view, integrity concerns relating to equity and revenue adequacy.

During consultation, stakeholders raised concerns about the operation of the law to deferred consideration arrangements which do not fall within the scope of the CGT look-through provisions.

Emerging risks identified

The Board was provided with examples where tax outcomes arising under the current law do not align with the economic outcomes pursuant to the transaction. Specifically, the Board was provided with examples of certain tax advantages that the Board considers inappropriate – in particular, the ability to enter into deferred consideration arrangements for business and asset purchases and, by virtue of the current operation of the tax law, claim multiple deductions for a single economic outflow or to receive a tax benefit where no economic outflow is made.

Also, taxpayers can effectively separate future gains from underlying taxable Australian real property, with these gains falling outside of the Australian tax net. This may adversely impact the equity of the corporate tax system, by providing preferential tax outcomes for foreign investors over resident investors.

The Board has concluded that these arrangements have the potential to erode the corporate tax base if left unchecked. The Board has been advised that in response to the outcomes arising from the current operation of the tax law taxpayers and their advisors are pursuing structured outcomes to optimise tax outcomes and to mitigate perceived tax risks in respect of deferred consideration arrangements.

Further investigation of the growing prevalence of deferred consideration

The ATO has stated that while it does not currently have any concerns about taxpayers' compliance with the law in this regard, it will undertake further work on the issues identified by the Board. While the Board's concerns largely relate to matters of policy, rather than administration, any intelligence the ATO may provide on this emerging issue will greatly benefit the Government's decision making process.

The Board, informed by its stakeholders in business and the tax community and further anecdotal evidence, understands that deferred consideration arrangements are becoming more prevalent and of higher economic consequence (increasing the significance of the tax consequences), in particular in both public and private large market transactions:

- Deferred consideration arrangements are now becoming more prevalent over operational assets, often with multi-billion dollar values, where the deferred consideration rights therefore have material value.

- Traditionally, deferred consideration arrangements were more common in respect of speculative assets (for example exploration projects) where the deferred consideration right more commonly had little or no value at inception.

- There are a number of areas of complexity and uncertainty regarding the operation of the tax law to these transactions, which increase uncertainty and risk.

The Board is also concerned that the misalignment between tax and economic outcomes may stifle commercial activity if not addressed. The misalignment arises because the operation of the law does not effectively reconcile the ultimate profit or loss of entities following the sale of assets, in particular where subsequent receipts are recognised as both capital proceeds and income. This leads to inappropriately high tax burdens (ie, potential double taxation) and the potential for excessive tax benefits.

Taxpayers concerned about higher tax burdens are ‘self-solving’ to minimise these outcomes, but the Board understands these solutions are imperfect and may lead to increases in disputes with the ATO.

The ATO has also raised concerns about whether taxpayers and their advisers have carefully considered the possibility that upfront tax liabilities may offset subsequent tax advantages (ie, through CGT events D1 and D3). The Board considers that more work is needed in this regard and would encourage taxpayers to seek further advice and guidance from the ATO where the tax outcomes are uncertain to avoid future disputes. However, should these upfront tax liabilities apply more generally to deferred consideration, the Board is concerned that these uncommercial outcomes would be inappropriate and may stifle commercial activity.

Reform and guidance

The Board considers that the identified tax anomalies, both advantageous and adverse, together with the associated structuring and conduct are distorting commercial transactions, and reducing the economic efficiency and revenue adequacy of the corporate tax system. The misalignment of tax and economic outcomes also has the potential to stifle commercial activity.

Given the relative ease through which taxpayers can avail themselves of the tax advantages, the Board expects these practices to quickly develop into established industry norms. The Board considers that more compliance and consultation activities from the ATO can inform the Government’s deliberations in this regard and encourages such activities to be undertaken. Further public guidance may also assist to clarify the matters of policy identified by the Board that highlight the lack of alignment between tax and economic outcomes.

Notwithstanding, the Board believes the Government has an opportunity to address these trends before the proliferation of such norms entrench the adverse impacts on economic efficiency and revenue adequacy over time. As such, the Board has set out a number of options for the Government to consider.

The Board’s preferred solution is that the Government address this issue as a matter of priority through a legislative measure designed in accordance with the principles set out in the Board’s report. The introduction of a targeted legislative regime based on the broad principles in the Board’s report will eliminate certain tax risks, while ensuring that tax issues do not prevent commercial transactions proceeding, leading to increased business activity and investment.

It is the Board’s strongly held view that such a legislative approach should only be adopted on a holistic basis; that is, addressing both sides of the transaction concurrently. This will have the effect of pre-empting integrity issues in the corporate tax system, while providing better certainty within a complex area of tax law. The Board does not expect a legislative solution to materially increase complexity, and that any complexity is outweighed by the benefits of reducing inefficiency and uncertainty.

While the Board considers a targeted solution to be necessary in this regard, the Board also considers that there is an opportunity for the Government to commission a separate, broader review into the systemic misalignment of tax and economic or commercial outcomes. Such a review would extend beyond the scope of this report (and deferred consideration), to consider other instances in which this misalignment occurs – in particular, within the CGT and UCA regimes. This presents an opportunity to address integrity concerns while simplifying the law for the benefit of a broad range of taxpayers and transactions.

Post-implementation review: regime operating as intended

The Board has determined that the rules in Subdivision 118-I are generally operating in accordance with their stated policy objective, having regard to the intentional scope limitations that are a design feature of the provisions.[1] The stated policy objective of the CGT look-through provisions is to:

> *'ensure that the CGT provisions do not present a deterrent to a specific type of transaction – the sale of a business where a genuine disagreement about the value of the business going forward is resolved by at least one of the parties agreeing to provided future financial benefits linked to the performance of the business'.*

Overwhelming feedback during the consultation process was received that various forms of deferred consideration arrangements are increasingly common. Stakeholders indicated that small-to-medium enterprise taxpayers are heavily reliant on the CGT look-through provisions, with many transactions structured to ensure they fall within the scope of the provisions.

The ATO's *Taxation Statistics 2015-16* state that over $170 million in capital gains have been reported under earnout arrangements in the last two income years to which the CGT look-through provisions apply. This tends to support overall stakeholder feedback.

The Board has identified two technical amendments that may improve the operation of the rules. These relate to the application provision for Part 3 of *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act 2016* (which introduced the CGT look-through provisions and related amendments), and the interaction between these rules and the taxation of financial arrangement (TOFA) regime.[2]

Stakeholders also raised a number of ancillary issues during consultation that give rise to varying levels of uncertainty about how the CGT look-through provisions are intended to operate. The Board has catalogued these concerns and recommended that the ATO consider providing binding public guidance on these issues. The Board does not consider that legislative amendments are warranted in respect of these issues or that the uncertainty adversely impacts the effectiveness of the provisions in achieving their policy objectives.

[1] For example, the 5 year period limitation that prevents the CGT look-through provisions from applying to longer-dated arrangements.

[2] Division 230 of the *Income Tax Assessment Act 1997*.

Board Recommendations and Observations

Key Recommendations: deferred consideration arrangements

Recommendation 6 The Board recommends that the ATO provide additional public guidance and undertake consultation in relation to the tax treatment of various forms of deferred consideration arrangements that fall outside of the scope of the CGT look-through provisions.
Recommendation 7 The Board recommends that the ATO may wish to consider increasing its information gathering or other compliance activities to improve the Government's understanding of the risks identified in relation to deferred consideration arrangements.
Recommendation 8 The Board recommends that, following consideration of the outcomes of the ATO's further work, the Government enact a targeted legislative regime for deferred consideration arrangements not covered by Subdivision 118-I, maintaining the general scheme of the Act to tax upfront the value of all proceeds received by a vendor on the disposal of assets, with targeted modifications to eliminate the potential for tax consequences that do not align with economic outcomes. The Board recommends that further consultation be undertaken on the design of such a regime in line with the principles identified by the Board. This consultation should take into account feedback from the ATO's public guidance and compliance activities.
Recommendation 9 The Board recommends that the Government conduct a holistic review of the design of income tax law to reduce instances where tax outcomes are not consistent with overall economic and commercial outcomes. In particular, this should include a review of the prescriptive nature of the CGT and UCA rules (for example, the anti-overlap and double deduction rules). The Board considers that it has identified an opportunity to not only address certain potential anomalies and uncertainties, but also simplify the tax law and prevent similar adverse outcomes arising under other arrangements.

Post-implementation review of the CGT look-through provisions

Recommendation 1

The Board recommends that the ATO publish binding guidance on the meaning of the phrase 'contingent on economic performance' in the CGT look through provisions.

If relevant stakeholders consider the ATO interpretation of this phrase is narrow in scope, the Board recommends that this issue should be revisited by Government to ensure that the provisions continue to achieve their legislative intent.

Recommendation 2

The Board recommends that the TOFA rules be amended to clarify that "look-through earnout rights" are excluded from the operation of TOFA.

Recommendation 3

The Board recommends that the ATO publish binding public guidance on what it considers are acceptable clauses in agreements regarding disputes and delayed payments, and examples of events resulting in delayed payments that may be contemplated in these arrangements, that would satisfy the conditions in subsection 118-565(3).

Recommendation 4

The Board recommends that the ATO note the tax consequences of assigning or otherwise disposing of look-through earnout right for future consideration in binding public guidance. If this issue cannot be resolved via administrative guidance, legislative amendments may be required.

Recommendation 5

Subject to clarification from the ATO (or through a court decision), the Board recommends that the application provision in Clause 38 of *Tax And Superannuation Laws Amendment (2015 Measures No. 6) Act 2016* be amended to reflect that the amendments apply for all purposes, and not just look-through earnout rights entered into on or after 24 April 2015.

Board observations

Observation 1

The Board considers that the ability to use deferred consideration arrangements to convert capital gains and losses from taxable Australian property into gains and losses from assets that are not taxable Australian property presents a revenue risk that should be addressed.

Observation 2

The Board observes that multiple tax advantages are available in relation to single economic outflows under deferred consideration arrangements in certain circumstances. Similarly, the Board observes that purchasers are able to obtain a tax advantage in circumstances even where no economic outflow is made. Such outcomes may lead to distortions of commercial transactions, reducing economic efficiency and may also have a negative revenue impact, which should be addressed.

Observation 3

The Board observes that certain adverse tax outcomes may arise for vendors under deferred consideration arrangements. In particular, these tax outcomes include double taxation of amounts characterised as both assessable income and capital proceeds, and circumstances of stranded cost base. These outcomes arise due to significant complexity in the tax law, but may ultimately lead to distortions of commercial transactions or taxpayers entering into questionable structures or legal positions to achieve greater alignment of tax and economic outcomes, all of which should be addressed

Observation 4

The Board observes that the possibility of differing valuations being adopted by purchaser and vendors under deferred consideration arrangements could exacerbate the other issues identified regarding the lack of tax and economic outcome alignment.

Observation 4

The Board observes that extending the operation of TOFA to deferred consideration arrangements not covered by Subdivision 118-I in a similar manner to the treatment of qualifying securities may address the anomalies and uncertainties identified.

However, the actual application of TOFA is unclear and potentially complex. In particular, the application of TOFA to arrangements covered by the CGT look -through provisions is uncertain and is the reason the Board as recommended the modification set out in Recommendation 2.

Observation 5

The Board observes that extending the operation of CGT look-through provisions would likely increase the cost of the concession. The Board does not consider that a concessionary approach is necessary in order to address the concerns identified.

GLOSSARY

The following abbreviations and acronyms are used throughout this report.

Abbreviation	Definition
ATO	Australian Taxation Office
CGT	Capital Gains Tax
Commissioner	Commissioner of Taxation
UCA	Uniform Capital Allowance
Draft Ruling	Taxation Ruling TR 2007/D10 (withdrawn)
DTA	Double Tax Agreement
ITAA 1936	Income Tax Assessment Act 1936
ITAA 1997	Income Tax Assessment Act 1997
PBR	Private Binding Ruling (also known as a Private Ruling) issued by the ATO under the Taxation Administration Act 1953
SME	Small-to medium enterprises
TAP	Taxable Australian Property
TARP	Taxable Australian Real Property
TOFA	Taxation of Financial Arrangements
TR	Taxation Ruling issued by the ATO under the Taxation Administration Act 1953

Chapter One: Earnout Arrangements and other forms of Deferred Consideration

KEY POINTS

- Deferred consideration arrangements have traditionally been most common in situations where the vendor and purchaser of a business or asset cannot agree on an upfront fixed price.
- These arrangements are common in a wide range of scenarios, and often include contingencies related to either or both the financial performance of all or a component of, the underlying asset or business, or upon external factors such as market prices or on certain milestones or events occurring.
- The income tax consequences of deferred consideration arrangements are complex, and can involve interactions between regimes or principles including:
  - the recently introduced 'look-through' CGT provisions for qualifying earnout arrangements;
  - general CGT provisions;
  - uniform capital allowance (UCA) regime;
  - taxation of financial arrangements (TOFA) regime; and
  - ordinary concepts of assessable income /allowable deductions.

Deferred consideration arrangements

1.1 In business transactions, a vendor and potential purchaser may not agree on an upfront fixed price for the business (or business assets[3]) to be transferred. To resolve this

[3] Hereafter, unless stated, references to a business being sold includes reference to business assets being sold without the transfer of a going concern business, and to the sale of an interest in an entity carrying on a business.

impasse, the parties may agree that as part of the consideration payable for the transfer of the business, amounts may become payable after completion of the sale, based on the future financial performance of all or a component of the assets or business, or upon external factors such as market prices or on certain milestones or events occurring. The resulting contractual right to such future amounts can be referred to in a number of ways, most commonly as either 'deferred consideration', 'earnout arrangements', 'royalty arrangements' or 'earnout rights'.[4]

1.2 Some arrangements involve the possibility of both the vendor and the purchaser being required to make future payments depending upon the qualifying conditions or contingencies for such subsequent payments.

1.3 Contemporary asset and business sales arrangements involving deferred consideration often include contingencies which dictate the obligation to make the future payments which may be calculated by reference to financial performance or determined by reference to events or factors other than the financial performance of the asset(s) or business transferred. Such factors can include (but are not limited to) the commencement of certain business activities, obtaining finance to fund a project, the price of a commodity achieving a certain level or a drug receiving regulatory approval.

1.4 Feedback received during the consultation sessions indicated that it is common for arrangements involving deferred consideration to have application for very long or potentially even indefinite periods depending on the nature of the contingency in the arrangement. A number of consultees informed the working group that in the mining, oil and gas and technology sectors, deferred consideration arrangements may include arrangements that require the purchaser to make payments to the vendor of an income or 'royalty' nature for periods often exceeding 30 years and at times involve contingencies with no end date.

1.5 Arrangements of the nature referred to in paragraphs 1.3 and 1.4 above may not reflect what is traditionally regarded as an earnout arrangement, being an arrangement intended to resolve differences in opinion about the value of a business at the time the business is sold based upon the business assets, characteristics and economic conditions existing <u>at that time</u>. Consequently for the purposes of this review, the broader concept of 'deferred consideration' has been adopted.

[4] Historically 'earnout arrangements' have been further categorised into two types: 'standard earnout arrangements', where the purchaser pays additional financial benefits to the vendor if specified financial performance conditions are met, and 'reverse earnout arrangements', where the purchaser pays the vendor a greater initial upfront payment amount and is required to pay back financial benefits if certain conditions are not met.

Types of deferred consideration arrangements

1.6 For the purposes of this review, deferred consideration arrangements are arrangements whereby the parties cannot agree on the current value of some or all of a business or assets due to uncertainty about the future economic performance of the business or assets and agree to resolve this uncertainty by agreeing to potentially provide future additional consideration linked to this performance and/or other commercial parameters.

1.7 Under these arrangements, a portion of the consideration for the acquisition of a business or asset is uncertain at time the right is created as a consequence of the contingencies agreed between the parties.

1.8 This review is not intended to address commercial arrangements whereby the vendor receives, as part of the consideration for the disposal of an asset or a business, an equity interest in either the purchaser or the business or asset being disposed of. Importantly, deferred consideration arrangements that the Board has considered would not be equity interests as defined in section 974-70 and 974-75.

1.9 Under item 2 of the table in subsection 974-75(1), an interest that carries a right to a variable or fixed return from a company that is, in substance or effect, contingent on aspects of the economic performance of the company or a part of the company's activities is an equity interest. However, subsection 974-75(2) prevents an interest from being characterised as an equity interest if it is not a financing arrangement for the company. A financing arrangement is defined[5] as a scheme that is entered into or undertaken to raise finance for the entity, or to fund another scheme, or the return payable under another scheme, that is a financing arrangement.

1.10 As outlined above, a defining feature of deferred consideration arrangements is that they are entered into to address differences of view as to the value of those assets. The arrangements are not intended to provide finance to the purchaser, and do not include other features typical to equity interests (such as rights to vote or rights on winding up). Accordingly, the types of arrangements considered in this report are not intended to cover equity interests as defined for tax law purposes.

Current Tax Framework

1.11 The remainder of this chapter provides a high level overview of the tax provisions that can apply to deferred consideration arrangements.

[5] Section 974-130.

CGT look-through provisions

1.12 Subdivision 118-I of the *Income Tax Assessment Act 1997* (ITAA 1997 or the Act) contains the core provisions for CGT 'look-through' treatment of qualifying transactions.[6] The provisions were enacted by Schedule 1 to the *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act 2016*, and apply to qualifying arrangements entered into on or after 24 April 2015.

1.13 The legislation sets out the object of the rules as follows:

The object of these rules is to avoid unnecessary compliance costs and disadvantageous tax outcomes when entities involved in the sale of a business:

(a) cannot agree on the current value of some or all of the business' assets due to uncertainty about the future economic performance of the business; and

(b) resolve this uncertainty by agreeing to potentially provide future additional consideration linked to this performance.[7]

1.14 The underlying principle of a look-through approach is to disregard the tax consequences relating to the earnout right as a separate asset and treat all payments made under the relevant contractual arrangement as relating to the underlying transaction for CGT purposes.[8]

1.15 The tax outcomes that arise under this look-through approach are considered to be concessionary as it overrides the general scheme of the Act, which would otherwise treat the right as a separate asset in the hands of the vendor, and tax the value of that right up-front. The CGT look-through provisions essentially "follow the cash" for both the vendor and the purchaser – ie, the vendor and the purchaser receive tax recognition for amounts receive/paid under the earnout right as those amounts are received/paid.

1.16 CGT look-through treatment is available for qualifying transactions referred to as 'look-through earnout rights'.[9]

1.17 The eligibility requirements for look-through earnout rights are intended to limit the application of the rules to arrangements where there is a genuine disagreement regarding the value of the business. The scope of the rules was also limited in other respects in order to appropriately target what is in effect a concessionary tax treatment.

---

[6] All legislative references in this report are to the *Income Tax Assessment Act 1997* unless otherwise stated.
[7] Subsection 118-560(1).
[8] The Treasury *Capital gains tax treatment of earnout arrangements* Proposal Paper, May 2010, page 3 < https://archive.treasury.gov.au/documents/1801/PDF/DP_CGT_treatment_of_earnout_arrangements.pdf >
[9] Subsection 118-565(1).

1.18 The qualifying conditions can be summarised as follows:

(a) it is a right to future financial benefits that are not reasonably ascertainable;

(b) the right is created under an arrangement involving the disposal of an asset that causes CGT event A1 to occur;

(c) the CGT asset was an active asset;

(d) all the financial benefits are to be provided within a 5 year period;

(e) the financial benefits are contingent on economic performance of the asset or business;

(f) the value of the financial benefits is related to that economic performance; and

(g) the parties dealt at arm's length in making the arrangement.

1.19 The tax consequences of a right being classified as a look-through earnout right can be summarised as follows:

(a) The market value of the right is not included in the vendors capital proceeds on disposal of the asset[10] or the purchaser's cost base on acquisition of the asset;[11]

(b) Any capital gain or loss that would otherwise arise as a consequence of the granting or cessation of a look-through earnout right is disregarded;[12]

(c) The capital proceeds for the disposal of the original asset(s) are adjusted for any subsequent financial benefits actually provided or received by the vendor;[13] and

(d) The cost base of the asset(s) acquired by the purchaser is adjusted for any subsequent financial benefits actually provided or received by the purchaser.[14]

1.20 The CGT look-through provisions also include integrity rules (for example, the vendor is prevented from recognising all or part of a capital loss on disposal if that loss could be subsequently eroded by future receipts under the look-through earnout right), and consequential amendments to the small business CGT concessions and amendment period rules.

---

[10] Subsection 116-120(1).
[11] Subsection 113-36(1).
[12] Section 118-575.
[13] Subsection 116-120(1).
[14] Subsection 113-36(1).

1.21 The application of the CGT look-through provisions is limited to transactions involving assets that are brought to account under the CGT provisions. Transactions involving depreciating assets (which would be dealt with under the UCA regime), or revenue assets (which would be dealt with under ordinary income/deduction principles) are not able to benefit from the look-through approach.

1.22 There is no specific provision which 'turns-off' the TOFA provisions, even if an arrangement qualifies for treatment under the CGT look-through provisions.

Taxation of financial arrangements (TOFA) provisions

1.23 Deferred consideration arrangements may fall within the scope of the TOFA provisions in Division 230 of the ITAA 1997 where, broadly, they are financial arrangements, and not subject to a specific exception in Subdivision 230-H.

1.24 There are a number of hurdles that must be overcome for a deferred consideration arrangement to be subject to TOFA. These include:

(a) The vendor or purchaser may be carved out of TOFA by the exception for smaller taxpayers with no significant deferral;

(b) The deferred consideration arrangement must be a financial arrangement.[15] The arrangement may not satisfy this definition if it comprises significant non-cash settlable financial benefits (for example, obligations on the vendor to do something);

(c) If the arrangement is an 'equity interest' for tax purposes, TOFA will have limited operation;[16]

(d) The arrangement may be subject to an exception if all financial benefits are to be provided within 12 months of completion of the sale;[17] and

(e) The arrangement may be subject to a specific (but limited) exception that is intended to carve out certain types of earnout arrangements from the operation of TOFA.

1.25 These issues have created significant uncertainty regarding the types of deferred consideration arrangements which fall within the scope of TOFA.

---

[15] Defined in section 230-45.
[16] Refer to section 230-50 and subsection 230-40(4).
[17] Section 230-450.

1.26 Where TOFA applies to a deferred consideration arrangement, the broad scheme of the Act will apply to treat the deferred consideration arrangement as a separate "arrangement" to the sale transaction, and recognise the value of the deferred consideration arrangement up-front for both the vendor and purchaser. The TOFA regime then provides the mechanism by which any gains and losses arising under the deferred consideration arrangement will be assessable or deductible to the relevant taxpayer. Gains and losses will arise as a consequence of the contingency, and should ultimately be equal to the difference between the market value of the arrangement at inception and the nominal value of payments received or provided over the life of the arrangement. There is some complexity involved in determining the time at which these gains and losses are brought to account under the default methods in TOFA. The following simplified example broadly illustrates the operation of TOFA when applied to deferred consideration arrangements which are subject to TOFA.

Example 1.1

As part of a transaction to sell a business asset, a purchaser grants a vendor the right to receive three annual payments of up to $100 each (ie, potential total payments of $300) calculated by reference to the turnover of the business. At the time of the grant, the market value of the right is $150.

The vendor subsequently receives the following amounts under the deferred consideration right:

- Year 1: $90;
- Year 2: $50; and
- Year 3: $30.

Assume for the purpose of this example that the arrangement is subject to TOFA, and does not qualify for 'look-through' treatment under Subdivision 118-I.

The following tax consequences arise for the vendor:

- For CGT, the vendor recognises capital proceeds of $150 on disposal of the asset.
- For TOFA, upon receipt of each amount the vendor recognises a gain or loss equal to the difference between the amount received and a portion of the upfront 'cost' of the arrangement that is reasonably attributable to the amount received. There is some uncertainty regarding how this apportionment should be done. For the purposes of this example, the $150 'cost' has been apportioned to the receipts on a straight line basis[18]. Accordingly, the vendor would recognise:
  - A $40 gain in Year 1 ($90 receipt less $50 cost)
  - No gain or loss in Year 2 ($50 receipt less $50 cost)
  - A $20 loss in Year 3 ($30 receipt less $50 cost)

In summary, the vendor has recognised $170 for tax purposes ($150 as capital proceeds and a net gain of $20 under TOFA) in relation to total economic inflow of $170.

[18] Under section 230-70 of the ITAA 1997, the attribution of amounts previously provided must reflect appropriate and commercially accepted valuation principles that properly take into account the nature of the rights and obligations under the financial arrangement, the risks associated with each financial benefit, right and obligation under the arrangement and the time value of money. A straight line basis may not be appropriate in these circumstances. This has been used for illustrative purposes only.

Application of other tax provisions

1.27 Deferred consideration arrangements that do qualify as look-through earnout rights and do not fall within the scope of TOFA are broadly dealt with under the general tax rules which may include some or all of the CGT provisions, capital allowances regime, and ordinary rules for assessable income and allowable deductions. These types of arrangements have given rise to complex tax issues for taxpayers and the ATO for many years before the introduction of Subdivision 118-I, and continuing now for non-qualifying transactions.[19]

1.28 Under the CGT provisions, capital proceeds for the vendor for the disposal of a CGT asset comprises money received (or entitled to be received) and the market value of any other property received as consideration for the disposal of a CGT asset.[20] Similarly, the first element of the cost base of a CGT asset for the purchaser includes money paid (or required to be paid), and the market value of any other property given in respect of requiring the CGT asset.[21] Accordingly where the asset in question is a CGT asset, both the vendor and the purchaser will be required to value the deferred consideration right up front in order to bring to account that value in the disposal proceeds for CGT purposes (for the vendor) and to determine the cost base of the acquired asset (for the purchaser).

1.29 Similarly, under the capital allowances provisions, the amount considered received by the vendor for balancing adjustment purposes,[22] or for the cost of a depreciating asset acquired for a purchaser,[23] will include an 'amount' paid/received or as a '*non-cash benefit' provided/received for the depreciating asset. Accordingly where the asset in question is a depreciating asset this requires both the vendor and the purchaser to value the deferred consideration right up front in order to bring to account that value in the balancing adjustment calculation (for the vendor) or to determine the depreciable basis (for the purchaser).

1.30 The ATO's historic view as to the CGT consequences of certain deferred consideration arrangements was outlined in draft Taxation Ruling TR 2007/D10 (Withdrawn) *Income tax: capital gains: capital gains tax consequences of earnout arrangements* (Draft Ruling). This draft ruling has been withdrawn; however, the notice of withdrawal states that the view in the ruling continues to be the ATO's view to the extent to which the arrangement in question falls within the scope of the Draft Ruling. The withdrawn Draft Ruling considered the CGT treatment of 'standard earnout rights', which was generally considered to be arrangements that provide for payments over a period of between one

[19] The Commissioner has issued a number of rulings seeking to address the difficulties and uncertainties, including TR 93/15, TR 95/35, TR 1999/19 and TD 93/86.
[20] Subsection 116-20(1).
[21] Subsection 110-25(2).
[22] Subsection 40-305(1).
[23] Section 40-185.

and five years and are focused on the value of the business sold only (but did not address the consequences under the UCA regime). Throughout this report, references to 'deferred consideration rights' or similar are not limited to the rights covered by the Draft Ruling, but includes any right that falls within the broad definition in paragraph 1.6 of this report.

1.31 In the withdrawn Draft Ruling, the Commissioner broadly indicated that in his view a right to receive a future unascertainable amount under a standard earnout right or reverse earnout right (Earnout Right) is not an entitlement to receive money pursuant to the contract by which the asset is disposed, but rather is 'other property…received' by the seller as part, or all, of the consideration received for the asset disposed/transferred.[24] That is, an Earnout Right is a CGT asset in itself and any payments made under the Earnout Right is in respect of that right and not the original asset that was disposed of. Accordingly, the market value of the right is included as capital proceeds for the vendor, and cost base for the purchaser under the CGT provisions.

1.32 If the Commissioner's position expressed in the Draft Ruling were to be applied for capital allowance purposes, a deferred consideration right analogous to an Earnout Right would be a '*non-cash benefit' for the purposes of determining the cost of the depreciating asset for the purchaser, and calculating the balancing adjustment for the vendor.

1.33 In accordance with the withdrawn Draft Ruling, the right is considered to be a separate CGT asset from the assets originally disposed of and any receipts of future financial benefits by the vendor under that right will then have CGT consequences. Any amounts received will broadly be treated as capital proceeds for the ending, or partial ending, of a CGT asset (being the right or a number of separate rights) under CGT event C2.[25]

1.34 Accordingly, the vendor will be subject to taxation up front on the value of the right under either the CGT or the UCA assets depending on the nature of the asset disposed of. The right will be a separate CGT asset with a cost base equal to the market value of that right. Future receipts under the right will likewise be taxable under the CGT provisions and will be fully or partially offset by the cost base of that right to the extent to which there is an ending or a partial ending of the right as a consequence of the payment.

[24] Draft Ruling, paragraph 12.
[25] Section 104-25 – Cancellation, surrender and similar endings of intangible CGT assets.

1.35 It is also possible that the granting of the right to deferred consideration could trigger CGT events D1 (or CGT event D3 where the right involves income from mining) for the purchaser. There are, however, a number of carve outs from CGT event D1, for example, where the right is created by borrowing money or obtaining credit from another entity.[26]

1.36 There is significant uncertainty regarding the tax consequences of subsequent payments made by the purchaser under deferred consideration arrangements. The withdrawn Draft Ruling indicated that in the Commissioner's opinion, payments required to be made by the purchaser to the vendor pursuant to the Earnout Right have no effect on the cost base of the asset acquired, and does not address whether the purchaser can enjoy the value of those payments pursuant to any other provision of the Act. The ATO has issued a number of Private Rulings indicating that subsequent payments in excess of the market value of the right do not fall within the scope of section 40-880 for business related capital expenditure.[27] This means that there may be no tax recognition for amounts paid in excess of the market value of the right at the time of creation. Feedback received during consultation suggests that there is no consistent approach to the treatment of such payments by taxpayers.

1.37 The withdrawn Draft Ruling does not provide guidance on the taxation treatment of deferred consideration arrangements where the payments are, in accordance with tax principles, ordinary income to the vendor, or allowable deductions to the purchaser, commonly called 'royalties' in certain industries (Income Rights).

1.38 Where a vendor receives an amount under an Income Right, it is generally considered that the full (gross) amount of each payment received is required to be included in assessable income without any deduction or netting for any amount previously recognised in the calculation of the gain or loss from the disposal of the original asset.[28] In these cases, there is uncertainty as to when, and if at all, the vendor can receive a tax benefit for the cost base resulting from the market value of the right that was taxed up front as proceeds on disposal of the original asset.

[26] See Section 104-35 – CGT Event D1 Creating contractual or other rights and section 104-45 of the ITAA 1997 – CGT Event D3 Granting a right to income from mining.

[27] See PBR Authorisation numbers 94105 and 93599.

[28] There may be instances where the acquisition transaction could be considered to be on revenue account and as a consequence, a net profit basis or other tax basis may provide a deduction for the value of the Right. However, for the purposes of this report, it shall be assumed the transaction is not on revenue account. Further, see *Ivanac v Deputy Commissioner of Taxation* 95 ATC 4683 (*Ivanac case*).

1.39 For the purchaser granting an Income Right, the outcome is often more straightforward in that the amounts paid under the right will generally be allowable deductions.[29] Further, despite the market value of the Income Right being taken into account for determining the tax attributes (i.e. the cost base or depreciable cost) of the asset acquired, any payments made pursuant to the right would represent an additional deduction.

1.40 Throughout this chapter, the value of the right (whether an Income Right, Earnout Right or other right as identified) is included when calculating gains or losses under CGT, UCA or TOFA. This requires the relevant taxpayers (both vendors and purchaser) to undertake independent valuations. The potential influence of valuations in determining the tax outcomes for deferred consideration arrangements are explored later in this report.

[29] See *Cliffs International Inc. v Commissioner of Taxation* (1979) 142 CLR 140 (*Cliffs case*).

CHAPTER TWO: POST-IMPLEMENTATION REVIEW OF THE CGT LOOK-THROUGH PROVISIONS

KEY POINTS

- The CGT look-through provisions are generally operating as expected and in line with the policy intention.
- Most taxpayers are able to self-assess that transactions qualify for the concession, with low levels of ATO interaction.
- The Board has identified a limited number of uncertainties that can be addressed; in particular:
  - legislative certainty should be provided regarding the interaction between the CGT look-through provisions and TOFA; and
  - additional guidance should be provided by the ATO on the interpretation of certain aspects of the provisions.

Post-implementation review: summary

2.1 The Board's post-implementation review of the CGT look-through provisions focused on the following matters:

(a) the extent to which the provisions are achieving the intended policy;

(b) whether any problems with the operation of the rules have been identified, and

(c) for problems identified (if any), whether a legislative or non-legislative solution can alleviate the problem.

2.2 The Board's assessment of the effectiveness of the CGT look-through provisions is based on the information collected from stakeholders and the ATO via submissions received and the consultation meetings. Clear themes emerged from the consultation process.

2.3 The Board considers that the provisions have largely achieved the policy objectives of:

(a) reducing the compliance burden on small and medium enterprise taxpayers that enter into certain types of deferred consideration arrangements; and

(b) ensuring the CGT regime is not a deterrent to the sale and purchase of businesses and business assets.

2.4 The Board has formed this conclusion based upon stakeholder feedback that indicates many business sale transactions in the SME segment have been able to be structured to qualify for CGT look-through treatment, and based on advice received from the ATO that the number of enquires received regarding the application of the rules has been low.

2.5 It is the Board's view that while the rules are prescriptive and the scope of the provisions very targeted, the provisions are adequate.

Are the rules achieving the policy objective?

2.6 The Board's review focused on whether the CGT look-through provisions achieved their stated aim to 'ensure that the CGT provisions do not present a deterrent to a specific type of transaction – the sale of a business where a genuine disagreement about the value of the business going forward is resolved by at least one of the parties agreeing to provided future financial benefits linked to the performance of the business'.[30]

2.7 Consultees, based upon their experience, broadly considered the application of the provisions achieved the policy objective with consultees acknowledging that the 5 year limitation period was an intentional policy decision taken by Government.

2.8 Consultees were not aware of the rules causing any business sales not to proceed. Rather, consultees indicated that in the SME segment the parties to the transaction structured any deferred consideration arrangements in order to ensure that the transaction qualified for CGT look-through treatment. Consequently, consultees considered negotiations between SME vendors and purchasers are conducted on the basis the arrangement needs to fall within the scope of the rules.

2.9 This emphasis on compliant arrangements suggests that where transactions may have otherwise concluded on terms that did not qualify, the incentive to augment, or modify, these transactions is significant due to the preferential tax outcomes and compliance cost savings (noted further below at paragraph 2.12(d)).

[30] Paragraph 1.28 of the *Explanatory Memorandum.*

2.10 The relevance and importance of the provisions to the SME segment was supported by observations from consultees that precedent business sales contracts prepared by law firms are drafted consistent with the requirements of Subdivision 118-I, so that transactions can easily qualify for CGT look-through treatment.

2.11 Despite this, it was noted that it was not uncommon for the parties to agree certain terms and conditions relating to deferred consideration arrangements that present some uncertainty as to whether the executed arrangement satisfies the conditions for CGT look-through treatment. In such situations, the vendor and their advisers generally adopt a position that the CGT look-through provisions should nevertheless apply. These uncertainties are discussed further later in this chapter.

Stakeholder feedback

2.12 Feedback from consultees indicated that the CGT look-through provisions are generally achieving their policy objectives by:

(a) ensuring tax is not payable by vendors until after the vendor has received the cash and therefore the possibility of having to pay tax on amounts not yet received is not a deterrent for a vendor entering into a commercial transaction involving an earnout arrangement. No consultees expressed concerns regarding the loss deferral integrity measure that prevents a vendor from recognising some or all of a capital loss on disposal if that loss could be subsequently eroded by future receipts under the look-through earnout rules;

(b) facilitating flexible pricing negotiations for business transfers. Consultees considered the rules increased the willingness of parties to enter into and conclude business sales arrangements in the SME space;

(c) ensuring that vendors retain access to small business CGT concessions, so this does not act as a deterrent to enter into transactions containing earnout arrangements;

(d) reducing tax compliance costs and risks. Tax compliance costs are reduced by virtue of the fact that neither the vendor nor the purchaser needs to undertake valuations to comply with their tax obligations. As no valuation is required, tax risk is reduced as the accuracy of a valuation of the business or the earnout right is not open to challenge by the ATO. The compliance costs associated with the potential need to amend prior year tax returns was not raised as an issue by any consultees;

(e) reducing complexity and uncertainty as a consequence of the relative simplicity of the look-through provisions as compared with the application of the broader tax laws;

(f) removing potentially disadvantageous tax outcomes arising from the approach outlined in the withdrawn Draft Ruling (see discussion in Chapter 1).

2.13 The Board notes, however, that while the policy objective *prima facie* appears to have been met, the adoption of a 'look-through' approach may nevertheless be causing some distortions in commercial transactions as a consequence of the parties modifying their commercial arrangements in order to qualify for CGT look-through treatment, or to maximise potential benefits that can arise from the application of the rules.

2.14 The Board also notes that because the provisions do not apply to all arrangements involving deferred consideration, the rules serve to further highlight the potential integrity risks and disadvantageous tax outcomes associated with non-qualifying transactions.

Large market transactions

2.15 Although it was evident from the consultation process that a significant proportion of large transactions in the mining, oil and gas sectors do not qualify for CGT look-through treatment, there was no feedback from these industry sectors that the CGT look-through provisions were failing to achieve their intended policy objectives.

2.16 Stakeholders from these industry segments accepted that the transactions occurring in their industry segment would not generally qualify for the CGT look-through provisions due to the fact the commercial arrangements would not meet the eligibility criteria, in particular due to the term of the arrangements exceeding the 5 year period in the look-through rules. It was acknowledged by stakeholders that whilst it would be desirable for the look-through treatment to extend to all deferred consideration arrangements, the scope of the provisions was deliberately limited in recognition of the concessionary nature of those rules. These stakeholders did however express concerns about how the broader tax laws apply to deferred consideration arrangements that fall outside of the CGT look-through provisions. See Chapter 3 for further discussion of these issues.

Are the rules workable?

2.17 Throughout consultation stakeholders indicated that transactions in the SME space generally qualified for the CGT look-through treatment. While a number of stakeholders expressed a view that the provisions are overly prescriptive, no insurmountable difficulties were noted. Overall, stakeholders considered the provisions were capable of being complied with on a self-assessment basis.

2.18 The Board has also considered the limited quantitative data that is publicly available to confirm stakeholder feedback that the CGT look-through provisions are being used in practice.

2.19 According to the most recent Taxation Statistics released by the ATO, over $340 million in capital gains have been made under earnout arrangements in the last four income years, and over $1 billion in capital proceeds has been reported by vendors.[31] This includes $170 million in capital gains during the two income years of operation of the CGT look-through provisions (since 24 April 2015).[32]

2.20 The ATO's statistics reflect significant utilisation of earnout arrangements and, in particular, the CGT look-through provisions in the first two income years of operation.

2.21 Stakeholders however did identify a number of issues where they considered further clarification would be welcomed. These are detailed in the following sections of this chapter.

2.22 The ATO advised the working group that it was not previously aware of many of the concerns raised by stakeholders during the consultation process. At the time of consultation, the ATO had only received a very small number of requests for assistance by way of phone enquiries and private ruling (commonly 'PBR') applications relating to the application of the CGT look-through provisions.

2.23 Consultees advised that obtaining certainty by way of a PBR is not always practical in a business sales situation. This is because the ATO will only rule on actual transactions or final versions of sales agreements. By the time the agreements are in a form that the ATO is prepared to review, the parties involved generally do not wish to delay the transaction to allow additional time for the ATO to issue a PBR. The ATO noted during consultation that other forms of guidance are available to taxpayers which could overcome this issue (eg, a request for early engagement). Information about the types of guidance products available is on the ATO's website.[33]

2.24 The Board received consistent feedback throughout the review regarding a lack of binding public guidance as to how certain elements of the CGT look-through provisions would be administered by the ATO in practice. The ATO informed the Board that guidance on the application of the provisions is available on the ATO website[34]. In light of the low level of enquiry received by the ATO regarding the application of these provisions, the ATO was of the view that the level of guidance provided was sufficient and adequate.

---

[31] *ATO Taxation statistics 2015-16,* Table 1: Capital gains tax, Selected items, by entity, 2012-13 to 2015-16 income years, released 27 April 2018 <https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics-2015-16/?page=10#Capital_gains_tax>

[32] Returns featuring earnout arrangements between 11 May 2010 and 23 April 2015 are protected by clause 39 of the *Tax And Superannuation Laws Amendment (2015 Measures No. 6) Act 2016* (applying analogous treatment so section 170B of the *Income Tax Assessment Act 1936*).

[33] ATO website, *Advice and Guidance* < https://www.ato.gov.au/general/ato-advice-and-guidance/ > (Last modified 30 May 2017).

[34] ATO website, *Earnout arrangements and CGT*< https://www.ato.gov.au/General/Capital-gains-tax/In-detail/Business-assets/Earnout-arrangements-and-CGT/> (Last modified 24 July 2017).

2.25 Stakeholders generally appreciated the constraints on the ATO in issuing PBRs in a timely manner. However, they did consider that this, together with a lack of public guidance binding on the ATO on the application of the CGT look-through provisions, resulted in taxpayers assuming a degree of additional and potentially unnecessary tax risk.

2.26 Consultees also noted that additional public guidance from the ATO could result in material cost savings for transactions in the SME sector. As it was broadly accepted in the SME space that the vendor will have an objective to ensure that the transaction qualifies for CGT look-through treatment, consultees considered that additional public guidance on what the ATO considers are acceptable features of an arrangement that qualifies for CGT look-through treatment would reduce transaction costs.

2.27 The Board considers that stakeholders have access to a significant amount of general guidance information regarding the application of the provisions via the public information provided by the ATO on its website and the *Explanatory Memorandum* to *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Bill 2015* (*Explanatory Memorandum*). However, the Board acknowledges these sources do not provide taxpayers with the same degree of certainty, nor the same level of comfort regarding tax outcomes as would be provided by binding public rulings.

2.28 The Board also recognises that uncertainty relating to new legislation should reduce over time as the provisions continue to operate and taxpayers and tax practitioners become more familiar with the requirements.

2.29 Overall, the Board considers that the CGT look-through provisions are largely workable in conjunction with the currently available guidance. However, there are a small number of issues identified during consultation where legislative clarification, and/or binding ATO guidance, is warranted to provide certainty to taxpayers. These are outlined below.

Issues identified during consultation

2.30 During consultation, stakeholders informed the Board of a number of concerns regarding elements of the CGT look-through provisions in Subdivision 118-I. The main issues raised by stakeholders during consultation (and discussed further below) were:

(a) the meaning of 'contingent on economic performance', and the need for clarity as to whether certain non-financial conditions can be included in an arrangement without causing it to not be eligible for CGT look-through treatment;

(b) the interaction of TOFA with the CGT look-through provisions;

(c) potentially adverse tax consequences that could arise if there is a dispute between the parties and the dispute resolution process adopted by the parties is not explicitly provided for in Subdivision 118-I – for example where the dispute resolution process extends beyond the 5 year period;

(d) an integrity risk relating to the disposal of a look-through earnout right by a vendor prior to all payments under the arrangement being received; and

(e) the operation of the application provision of the enacting Bill.

2.31 A number of other minor issues were highlighted during consultation, and these are set out in Appendix B. As a general observation, the Board considers many of the concerns raised by stakeholders can be adequately addressed through the issue of ATO guidance.

Contingent on economic performance

2.32 Many stakeholders expressed concern regarding the meaning of the undefined term 'contingent on economic performance' in paragraph 118-565(1)(f). Stakeholders were particularly concerned as to how the ATO may interpret the phrase from a tax administrative perspective. These concerns included:

(a) whether a financial benefit will be treated as 'contingent on economic performance' if it is contingent on a number of factors, some of which may not strictly be considered as relating to economic performance (for example, 'key man' retention clauses, customer-related contingencies). Whether the ATO will treat such factors as being contingent on economic performance, by adopting a 'de minimis' or 'bifurcation' approach such that the threshold conditions for a look-through earnout right can still be satisfied notwithstanding the existence these other factors;

(b) what (if any) non-financial factors could be considered contingent on economic performance;

(c) whether an earnout right based on another earnout right is considered to be contingent on economic performance of the asset or business; and

(d) whether an earnout right based on the relative performance of two businesses can be considered to be contingent on economic performance.

2.33 Stakeholders commented that these issues are common for earnout arrangements applicable to the SME sector, and often significant compliance resources are being applied in efforts to manage the potential tax implications that could arise from non-financial factors being agreed in sales arrangements. The resources include increased tax advisory services (ie, explaining the issues that need to be addressed), increased legal services (including negotiating and drafting terms to enable an arrangement to be compliant with Subdivision 118-I) and the additional time it takes the parties themselves to negotiate and agree on terms that enable the overall arrangement to satisfy the conditions of Subdivision 118-I. As noted earlier in this chapter, stakeholders also commented that this could be considered a distortion of commercial outcomes, as taxpayers may adopt certain terms that may not be in their commercial best interests (before tax) in order to satisfy these conditions.

2.34 Where non-financial factors influence the future earnout payments, the absence of relevant ATO guidance on the way in which the particular contractual feature will influence the transaction's tax outcomes results in taxpayers taking on an increased level of tax risk for transactions that stakeholders consider should qualify for CGT look-through treatment. Taxpayers and their advisers have needed to adopt a position as to whether the arrangement satisfies the requirements for look-through treatment despite uncertainty as to how the contingent on economic performance test will be administered. It would appear, however, that taxpayers are either unable (due to time constraints) or unwilling to seek binding guidance from the ATO on these issues in the form of PBRs.

2.35 The Board considers that the guidance in the *Explanatory Memorandum* should alleviate many stakeholder concerns. However, there is a need for additional ATO guidance on issues relating to the 'contingent on economic performance[35]'test that are not adequately addressed in the *Explanatory Memorandum*. The ATO may wish to undertake further consultation with stakeholders to identify examples on which guidance is required.

2.36 The Board notes that should the ATO guidance significantly narrow the scope of the CGT look-through provisions, there may be a need to revisit this issue to ensure the provisions continue to achieve their legislative intent.

2.37 Stakeholders also noted that the second requirement of the economic performance test (that the value of the financial benefits is related to economic performance[36]) suggests that a fixed sum (or even a security) may not qualify. Stakeholders also sought ATO guidance on this matter. In the *Explanatory Memorandum* this issue is considered to be fact dependent[37]. In these circumstances, comprehensive ATO guidance may be relatively resource intensive. Without proof of significant uncertainty, the Board cannot recommend this matter as an issue warranting prioritisation by the ATO.

---

[35] Any guidance provided by the ATO on the meaning of this phrase may also be relevant to the definition of 'contingent on aspects of the economic performance' in section 974-85 of the ITAA 1997.

[36] Paragraph 118-565(1)(g).

[37] See paragraphs 1.58 to 1.61, and example 1.2 (paragraph 2) of the *Explanatory Memorandum.*

RECOMMENDATION 1

The Board recommends that the ATO publish binding guidance on the meaning of the phrase 'contingent on economic performance' in the CGT look through provisions.

If relevant stakeholders consider the ATO interpretation of this phrase is narrow in scope, the Board recommends that this issue should be revisited by Government to ensure that the provisions continue to achieve their legislative intent.

Interaction of TOFA and Subdivision 118-I

2.38 As outlined in Chapter 1, some deferred consideration arrangements fall within the scope of TOFA as they meet the definition of 'financial arrangement'. However, the *Explanatory Memorandum*[38] notes that, from introduction, certain financial benefits arising directly or indirectly from business sales (such as earnout arrangements) are excluded from TOFA.

2.39 This was proposed to be achieved by subsection 230-460(13), which excludes certain earnout arrangements from the application of TOFA if the financial benefits payable under the arrangement are only 'contingent on economic performance'.

2.40 Legislative amendments made by the *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act 2016* replaced the concept of 'contingent on economic performance' in subsection 230-460(13) with a concept of 'contingent on aspects of the economic performance'. Subsection 974-85(1) seeks to limit the scope of the phrase 'contingent on aspects of the economic performance', and is relevant for the application of subsection 230-460(13). It provides that, if a financial benefit is solely determined by reference to the receipts or turnover of an entity or the turnover generated by activities of the entity, the financial benefit will not be considered to be 'contingent on aspects of the economic performance'.

2.41 As a consequence, rights and obligations to provide financial benefits that are contingent solely on receipts or turnover of a business may not be excluded from TOFA under subsection 230-460(13).

[38] See paragraphs 2.184 to 2.186 of the *Explanatory Memorandum.*

2.42 Stakeholders raised concerns that the concept of 'contingent on aspects of the economic performance' was narrower than the concept of 'contingent on economic performance' as used in Subdivision 118-I. The *Explanatory Memorandum* confirms that the concept of 'contingent on economic performance' is intended to be wider, noting that the fact that deferred consideration is calculated by reference to business receipts or turnover should not 'unduly limit the scope of the concession'[39].

2.43 The Board understands that this led to the new defined term 'contingent on aspects of the economic performance' being included as part of the TOFA regime.

2.44 Where TOFA applies to a financial arrangement, it generally has priority in application to other provisions of the tax law[40]. During consultation, stakeholders expressed concern regarding unintended and potentially adverse outcomes that could arise where an arrangement *prima facie* satisfies the conditions to be a look-through earnout right under Subdivision 118-I, but which also falls within the scope of TOFA.

2.45 Particular concern was expressed for SME taxpayers that are subject to TOFA by election. Some of these potential outcomes are highlighted in the simplified example below.

[39] Paragraph 1.142 of the *Explanatory Memorandum.*
[40] Sections 230-20 and 230-25.

Example 2.1

As part of a transaction to sell a business asset, a purchaser grants a vendor the right to receive a payment of up to $100 calculated by reference to the turnover of the business. At the time of the grant, the right is valued at $60.

The vendor subsequently receives $90 under the deferred consideration right. Assume for the purpose of this example that the arrangement qualifies as a 'look-through earnout right', and is also subject to TOFA as it does not meet the conditions for the exception in subsection 230-460(13).

The application of the law in these circumstances is unclear. Under one potential interpretation of the law, the following tax consequences may arise for the vendor[41]:

- The vendor initially recognises capital proceeds of Nil on disposal of the asset. Notwithstanding that section 230-505 requires the vendor to recognise market value consideration for the disposal, subsection 116-120(1) specifically states that capital proceeds do not include the value of any look-through earnout right.
- Upon receipt of the $90:
  - the vendor recognises a TOFA gain of $30 (being the $90 received less $60 cost of the right); and
  - no adjustment is made to capital proceeds on disposal of the asset. Whilst subsection 116-120(1) requires the cost base to be increased by any financial benefit received under a look-through earnout right, section 230-25[42] may prevent any amount being included in capital proceeds.

In summary, the vendor has recognised only $30 for tax purposes in relation to total economic inflow of $90. This can be contrasted with the following outcomes had either TOFA or Subdivision 118-I applied in isolation:

- *If TOFA applied*: the vendor would have recognised capital proceeds of $60, and a TOFA gain of $30 on receipt of the deferred consideration (total of $90 recognised for tax purposes)
- *If Subdivision 118-I applied*: the vendor would have recognised capital proceeds of $90.

[41] It is noted that the application of the law in these circumstances is unclear.

[42] This section provides that financial benefits in relation to TOFA financial arrangements are to be taken into account only once under the tax law.

2.46 The Board notes that there is no discussion in the *Explanatory Memorandum* to *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Bill 2015* regarding how the CGT look-through provisions and TOFA were intended to interact. However, the Board acknowledges there is potential for overlap in application of the two regimes where deferred consideration is calculated by reference **solely** to 'the receipts or turnover of the entity or the turnover generated by those activities' and this is considered to be a measure of economic performance for purposes of the CGT look-through provisions.

2.47 The Board considers that the potential for overlap between the two regimes in practice is limited as many SME taxpayers are not subject to TOFA, and the scope of TOFA to apply to such arrangements may be narrow[43]. The Board also notes that during the consultation process, no transaction was presented to the working group where the arrangement satisfied the conditions for CGT look-through treatment and also fell within the scope of TOFA.

2.48 Despite the fact that this may not be a frequent occurrence, stakeholders expressed concerns that this was a realistic possibility, and considered it would be inconsistent with the policy intent of the CGT look-through provisions if TOFA applied to such overlap situations.

2.49 The Board recommends that clarification that the CGT look-through provisions should apply to earnout arrangements to the exclusion of TOFA. This is consistent with the policy intent of both provisions.

2.50 The Board notes that this could be achieved by linking the threshold conditions of the CGT look-through provisions with the TOFA earnout arrangement exclusion under subsection 230-460(13).

RECOMMENDATION 2

The Board recommends that the TOFA rules be amended to clarify that "look through earnout rights" are excluded from the operation of TOFA.

[43] Although it is noted that during consultation, it was apparent that there were differing views between stakeholders and the ATO regarding the potential for TOFA to apply to deferred consideration arrangements.

Dispute resolution and the 5 year period

2.51 Broadly, for an arrangement to qualify for look-through earnout right treatment, all payments under the arrangement must be provided within 5 years of the end of the income year in which the relevant CGT event occurred. Subsection 118-565(3) provides for situations where payments outside of the 5 year period can potentially be disregarded for the purposes of determining if this condition is met. Under this subsection, the 5 year period will be taken to be met if the arrangement allows for an entity to defer the provision of a financial benefit if:

(a) the relevant contingency causing the deferral is outside the control of either party;

(b) when the agreement was entered into the contingency was not reasonably expected to happen; and

(c) the deferral cannot change the amount of any financial benefit payable under the agreement.

2.52 The *Explanatory Memorandum* to *Tax and Superannuation Laws Amendment (2015 Measures No. 6) Bill 2015* provides two examples of situations which fall within the scope of subsection 118-565(3). The first is where a party is late in providing a financial benefit under the look-through right[44] and the second is where the relevant agreement includes provisions that allow for a delay in payment contingent on certain stipulated events, such as a dispute over the terms of the agreement being subject to a binding arbitration process[45].

2.53 Stakeholders expressed concern during consultation meetings regarding how subsection 118-565(3) could potentially operate and more specifically how the ATO might administer the provision. By way of example, a consultee expressed concern that despite the arbitration example provided in the *Explanatory Memorandum*, the conditions for a look-through earnout right may not be satisfied if a dispute regarding the arrangement arose, and payments were delayed beyond five years solely because litigation, or some other dispute resolution mechanism, had commenced. The consultee suggested the conditions in subsection 118-565(3) could be considered failed as a decision to commence litigation is always a matter that is within the control of at least one of the parties to the agreement.

2.54 Consequently, stakeholders indicated it would be beneficial if the ATO would provide binding public guidance on what it would consider are acceptable clauses in agreements regarding disputes and delayed payments, and examples of factual scenarios resulting in delayed payments, that would satisfy the conditions in subsection 118-565(3).

---

[44] See paragraph 1.69 of the *Explanatory Memorandum.*
[45] See paragraph 1.70 of the *Explanatory Memorandum.*

2.55 Although the Board considers that a party's decision to delay a payment as a result of the commencement of litigation is likely sufficiently similar in principle to the examples in the *Explanatory Memorandum*, in light of the concerns raised by stakeholders during consultation, the Board considers the effective administration of the CGT look-through provisions would be improved if the ATO provided further public guidance as to how it will administer the provision.

2.56 The Board considers such guidance may also reduce taxpayer compliance costs in that standard documentation can be drafted by law firms consistent with the guidance, and taxpayers may be able to avoid the need to seek advice regarding whether certain proposed courses of action could have significant adverse tax implications.

RECOMMENDATION 3

The Board recommends that the ATO publish binding public guidance on what it considers are acceptable clauses in agreements regarding disputes and delayed payments, and examples of events resulting in delayed payments that may be contemplated in these arrangements, that would satisfy the conditions in subsection 118-565(3).

Disposal of look-through earnout rights

2.57 During the review, the Board became aware of a potential integrity concern regarding the disposal of look-through earnout rights held by vendors prior to all of the potential payments under the arrangement being received by the vendor.

2.58 Broadly, when a look-through earnout right is received as part consideration for the disposal of an asset, the right has a cost base equal to that part of the value of the original asset disposed by the vendor that is reasonably attributable to the acquisition of the right[46]. Despite the value of the earnout right being disregarded for CGT purposes under the look through rules (to the extent that it is not recognised as capital proceeds on disposal of the original asset), nothing in the relevant provisions prevents such a cost base arising or disregards the cost base of the right.

[46] Subsection 112-30(1).

2.59 Practically, if the vendor holds the look-through earnout right until it ends, the fact that the right has a cost base is irrelevant as CGT event C2 is disregarded when the right ends. However, if the vendor assigns the right to a third party (other than by way of novation[47]), then CGT event A1 should occur potentially resulting in a capital gain or loss. Whilst section 118-575 disregards a capital gain or loss arising from CGT events C2 and D1 in relation to look-through earnout rights, no provision applies to disregard an outcome arising from any other CGT event for the vendor. This can cause a capital gain or loss to arise for a vendor that would appear to be unintended.

2.60 It is possible that the right to receive a future certain financial benefit for the 'ending' of a look-through earnout right (the original right) will be deemed to also be a look-through earnout right by virtue of subsection 118-565(4), with the consequence that those future financial benefits will be treated as capital proceeds for the disposal of the original asset. However, this outcome is not certain as there is no explicit provision that disregards CGT Event A1 from happening when the vendor disposes of the original right, and it is not clear if a disposal under CGT Event A1 is a relevant ending for the purposes of subsection 118-565(4).

2.61 The *Explanatory Memorandum* states that "a right to receive payment for ending an earnout right generally includes a right to receive a payment for transferring the entitlement to payment to another, as the original entitlement has been lost"[48]. This suggests it was the Government's intention that a payment received for the assignment/disposal of a right should be included in capital proceeds for the disposal of the original asset as if it was a payment under the original look-through earnout right. However, the legislation may not currently support an interpretation consistent with such a view.

2.62 This issue was raised by a number of stakeholders during the consultation, and the Board understands that the ATO is aware of this issue. However, no information was provided to the Board regarding the prevalence of such arrangements. Without evidence of the existence of a secondary market for look-through earnout rights, the Board cannot recommend this matter as an issue warranting prioritisation by the ATO.

[47] This would result in the right ending, which would be a CGT event C2, and which is disregarded by section 118-575. Novation may be required or preferred so that the third party acquiring the earnout right has recourse to the original purchaser rather than relying on its equitable rights against the vendor.

[48] See paragraph 1.76 of the *Explanatory Memorandum*.

RECOMMENDATION 4

The Board recommends that the ATO note the tax consequences of assigning or otherwise disposing of look through earnout right for future consideration in binding public guidance. If this issue cannot be resolved via administrative guidance, legislative amendments may be required.

The operation of the application provision

2.63 Application provisions set out the date from which a new provision of the law shall apply (and for what purposes).

2.64 For tax purposes, an application provision generally ensures that superseded versions of the law remain in force, and can be applied, in making prior year assessments or in making assessments dealing with matters to which the new provisions do not apply.[49] That is, it is important to clarify the extent to which an application provision may apply.

2.65 The *Tax And Superannuation Laws Amendment (2015 Measures No. 6) Act 2016* (the 2016 Act) introduced the CGT look-through provisions. The application provision in clause 38 states: '*The amendments made by Parts 1 to 3 apply in relation to look-through earnout rights created on or after 24 April 2015*'.

2.66 The 2016 Act also included a number of consequential amendments to other parts of the ITAA 1997 (in Part 3 of the Act, and therefore subject to the application provision above). These amendments included:

(a) The substitution of the term 'contingent on economic performance' in the Debt/Equity Rules (subsection 974-85(1)) with the new term 'contingent on aspects of the economic performance'[50]; and

(b) Amendments to the TOFA provisions to replace references to 'contingent on economic performance' (both asterisked and un-asterisked references) with references to the new term '*contingent on aspects of the economic performance'.[51]

---

[49] Office of Parliamentary Counsel, Drafting Direction No. 3.2 *Taxation*, May 2013, page 6 <http://www.opc.gov.au/about/draft_directions.htm>

[50] As discussed above, s974-85(1) prevents a return that is contingent solely on the receipts or turnover of an entity or its activities from falling within the scope of the phrase 'contingent on aspect of economic performance'.

[51] Of note, the amendments replaced the un-asterisked reference in subsection 230-460(13). The subsection details whether or not the TOFA provisions apply to certain deferred consideration arrangements and the replacement may have changed how the provision applies at law.

2.67 During consultation meetings, stakeholders indicated that they considered the application provision as drafted had the potential to limit the application of the amendments to purposes related only to look-through earnout rights as defined in section 118-565 (ie, arrangements that qualify for the CGT look through provisions).

2.68 It is unclear from the interaction of the application provision and the TOFA and Debt/Equity amendments whether those amendments apply for all purposes of the Act. If not, this means that the entire Act applies differently for look-through earnout rights than for any other arrangement. The Board considers that this is unlikely to have been intended.

2.69 The Board consulted with stakeholders, including Treasury, regarding the intention of the application provisions as enacted and the effect of the particular wording adopted. The Board understands that, in accordance with the *Explanatory Memorandum*, the intention is that the application provision operates such that the amendments apply for all purposes of the Act.

2.70 The ATO has not published any guidance in this regard. It has advised the Board that it is aware of this issue but has not yet formed a view as to how the application provision should apply. The ATO acknowledges that there may be uncertainty about the interpretation of the application provision.

2.71 Should the ATO conclude that the correct interpretation is that the application provision applies otherwise than as intended (as outlined above), the Board recommends that an amendment to the law should be included in a miscellaneous technical amendments bill to clarify the operation of the provision and rectify a clear error.

RECOMMENDATION 5

Subject to clarification from the ATO (or through a court decision), the Board recommends that the application provision in Clause 38 of Tax And Superannuation Laws Amendment (2015 Measures No. 6) Act 2016 be amended to reflect that the amendments apply to for all purposes, and not just look through earnout rights entered into on or after 24 April 2015.

CHAPTER THREE: EMERGING DEFERRED CONSIDERATION TAX ISSUES

KEY POINTS

- There is strong anecdotal evidence of an emerging trend in the market for deferred consideration arrangements over significant, valuable operational assets where material payments are deferred and the arrangements are not covered by the CGT look-through provisions.
- These arrangements can give rise to tax outcomes that are not in accordance with the broader economic or commercial positions of the parties.
- Stakeholders have highlighted that, under these arrangements:
  - parties that receive tax advantages due to the operation of the current law may be incentivised to maximise these advantages through adopting high valuations;
  - parties that are disadvantaged by the operation of the current law are 'self-solving' to reconcile their economic/commercial and tax positions;
  - these arrangements can also undermine the taxation of Australian real property.
- Based on the feedback from trusted stakeholders and other anecdotal evidence, the Board considers that these transactions are growing in prevalence and that it is necessary to obtain further intelligence about taxpayer behaviour.
- The ATO has stated that while it does not currently have any concerns about taxpayers' compliance with the law in this regard, it will undertake further work on the issues identified by the Board. In particular, the ATO is considering potential public guidance on the application of the current law and work to obtain assurance on taxpayers' compliance with the current law.
- The Board considers that, dependent on the outcomes of the ATO's further work, legislative reform is likely needed and has set out potential design features to address these issues. The Board's recommendation is to address the identified anomalies for both the vendor and purchaser holistically, as a limited solution only addressing tax advantages to purchasers will likely impact adversely on commercial activity.

3.1 The Board, informed by its stakeholders in business and the tax community and further anecdotal evidence, has identified an emerging trend in the market resulting in the increasing prevalence of deferred consideration arrangements that are not covered by the CGT look-through provisions in Subdivision 118-I.

3.2 The Board considers that there are certain material anomalies and uncertainties with the application of the current law to such arrangements which the Government should be aware, as set out in this chapter.

3.3 The Board's analysis is divided into three parts:

(a) Part A – identifying emerging trends;

(b) Part B – identifying risks and policy issues;

(c) Part C – options for addressing risks and concerns.

Part A: Emerging trends for Deferred Consideration

3.4 During the Board's consultation and research, a variety of high profile, and high value, transactions that involved elements of deferred consideration were reviewed as well as extensive discussions with practitioners in this area.

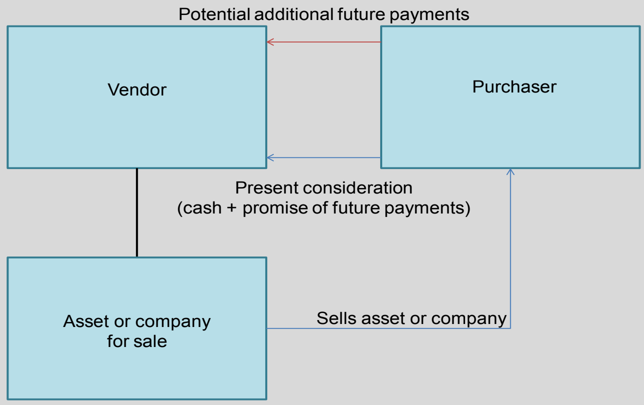
3.5 Transactions to which this chapter refers are generally outside the scope of the CGT look-through provisions unless otherwise stated. This is because the relevant large market transactions are complex and involve a variety of commercial drivers that are not suited to the limited scope of the look-through concessions.[52]

3.6 These transactions have a common underlying issue – a disconnect between the parties to the transaction of the current value of a business or assets the subject of the transaction. Parties negotiate the resolution of this disconnect by agreeing to potentially provide future additional consideration linked to future economic performance of the business, often the subject to various forms of contingency.[53]

3.7 A simplified diagram of a deferred consideration arrangement is provided below.

[52] These issues include a term of greater than five years or material contingencies not sufficiently linked to economic performance (such as regulatory approvals or commercial decisions – for example the decision to build a mine).
[53] See subsection 118-560(1).

Diagram 3.1: Deferred consideration arrangement



3.8 Under deferred consideration arrangements, tax is generally payable as follows:

(a) **Transaction taxing point**: at the time of the transaction, each party takes into account the cash and market value of any property transacted (ie, for revenue assets, depreciating assets or CGT assets);[54]

(b) **Subsequent taxing points**: following the transaction, each party takes into account any future related financial benefits transacted (ie, as ordinary income/deductions, capital proceeds/cost base etc.).

3.9 Corporate income tax systems ideally reconcile taxing points to reflect the underlying economic activity as the profit or loss of each party. However, difficulties arise due to the annualised nature of Australia's income tax system and the distinction it draws between whether a gain or loss is on revenue or capital account. These difficulties are explored further below.

Commercial drivers for deferred consideration

3.10 Based on the Board's consultation, the key commercial drivers are to provide for the deferral of a portion of the consideration in respect of the disposal of assets in order to address differences of view as to the value of those assets as a consequence of uncertainty over economic factors or the incidence of certain commercial or economic contingencies.

[54] Subsections 110-25(2) and 116-20(1) (for CGT events) and sections 40-185 and 40-305 (for balancing adjustment events).

3.11 While deferred consideration has been a feature of commercial transactions for many years, stakeholders have suggested that traditionally deferred consideration featured largely in transactions regarding highly speculative assets such as exploration projects, where the right to deferred consideration has little (or no) value and as such the scope for the concerns (which are discussed below) were very low.

3.12 Based on the arrangements that the Board has analysed, these arrangements are not ongoing equity interests of the vendor in the disposed asset and are not seen as akin to an ongoing equity interest in the underlying assets from a commercial perspective. These arrangements are entered into to resolve differences of view as to the valuation of the underlying asset, not to provide finance to the purchaser, and do not include rights to vote or distributions of capital. The Board therefore considers that in most cases the arrangements are not likely to be treated as equity interests for tax purposes.[55]

3.13 From consultation and its further independent review the Board considers that high value deferred consideration arrangements by major domestic and multinational enterprises are becoming increasingly prevalent, particularly in the energy and resources industry.

3.14 There are also some signs of this trend extending to other intellectual property (IP) intensive industries in Australia's technology sector (including 'med-tech', 'bio-tech' and other software development services), although the prevalence of such arrangements in that sector is uncertain.

3.15 Most importantly, based on the deferred consideration arrangements raised with the Board, they now more commonly feature in transactions relating to operational assets (such as mines) where the right to receive the deferred consideration is likely to have a material value, and therefore will have substantial tax consequences for both parties.

3.16 Throughout this process, stakeholders informed the Board that developments in commercial practices over recent years have meant it is now a common feature of commercial transactions to include arrangements under which a component of the consideration is deferred and referable to economic or operational/commercial outcomes which may occur in the future. A variety of reasons were given for this including:

(a) stricter investment policies (which tighten parameters around acceptable returns);

(b) less abundant capital in certain industries; and

---

[55] More information is provided in Appendix C. While there are commercial arrangements which involve vendors maintaining equity interests in sold assets or businesses, these transactions are not within the scope of the Board's enquiries.

(c) greater awareness of reputational risk when selling speculative assets that subsequently become highly profitable.

3.17 The Board's stakeholder feedback, publicly available data on recent transactions and the practical experience of the working group on transactions of this nature in recent years inform the following analysis.

Part B: Issues of concern to the Board

Current tax policy settings

3.18 The policy underpinning income tax laws generally means that companies only pay tax on profits. However, compliance costs and disadvantageous outcomes[56] can arise due to the technical and complex nature of, among other things, the transactional (or 'point-in-time') mechanisms in the income tax system.

3.19 For example, both the CGT and UCA provisions operate on the basis of a point-in-time analysis of cost and proceeds to determine the appropriate tax consequences for the income year in which the transactions occurs.[57]

3.20 While this is intended to provide greater certainty and administrative simplicity, it crystallises the tax consequences on an annual basis and leaves further reconciliation of the ultimate economic outcome of the transaction to other technical provisions of the law.

3.21 From its review, the Board has concluded that the operation of the tax law can result in outcomes that do not effectively reconcile the ultimate economic or commercial profit (or loss) from the transaction with the tax position of the relevant parties.

3.22 Feedback from stakeholders indicates that where adverse tax outcomes could arise for a taxpayer (ie, the amount taxed is greater than the economic or commercial gain made by the taxpayer), those taxpayers may seek to 'self-solve' by applying the TOFA provisions to the relevant transaction. From discussions with officials of the ATO throughout the working group process, it would seem that these methods (and associated legal analyses) are uncertain, leading to heightened risk of dispute with the ATO or an otherwise incorrect interpretation of the law.[58]

---

[56] This was identified as one of the reasons for introducing the look-through earnout right concession in Subdivision 118-I (see Subsection 118-560(1)).

[57] This general statement is subject to various modifications and special rules, such as the CGT look-through provisions.

[58] While this depends on the risk appetite of certain taxpayers, or the materiality of the transactions, the Board considers that this frank feedback highlights the existence of the underlying concerns.

3.23 However, for other taxpayers the Board considers that advantageous tax outcomes (eg, the tax law may recognise a greater tax benefit than the overall economic or commercial loss made by the taxpayer) can be obtained without taxpayers adopting “creative” or highly structured outcomes as they may simply flow from the widely accepted operation of the Act. These outcomes raise matters of policy.

3.24 The Board has prepared case studies that provide further information about the relevant transactions and tax consequences. These case studies are simplified versions of real-life transactions that were provided to the Board by its stakeholders and therefore may be evidence of wider problem with the operation of the current law.

3.25 Importantly, the transactions the Board was made aware of indicate there are different forms of contingency built into the commercial arrangements, different types of payments made under such arrangements (both revenue and capital in nature), and that arrangements can arise across market segments and industries (although the evidence made available to the Board indicates that currently they appear to be most prevalent in the energy and resources industry).

Tax axioms

3.26 The Board has considered whether the existing tax policy settings are appropriate in light of the identified risks and issues. In determining whether the existing law provides appropriate outcomes, regard has been had for the traditional tax axioms in the context of deferred consideration. In this particular instance, the following benchmarks have been adopted:

(a) **Economic efficiency (and integrity)**: whether the operation of the tax law presents a deterrent or a distortion to commercial transactions proceeding, or tax outcomes are being manipulated to provide tax-preferred outcomes that do not reflect the underlying economic activity;

(b) **Equity:** whether, from a whole-of-system perspective, asymmetrical tax outcomes adversely impact horizontal equity in respect of deferred consideration arrangements; and

(c) **Simplicity (and certainty)**: whether the tax law is disproportionately complex when applied to rights and obligations under the deferred consideration arrangement leading to heightened uncertainty and risk.

3.27 Significantly, the Board notes that deferred consideration arrangements are a good example of where there can be structural asymmetry (which affects the equity of the system) of taxation. While symmetry between two parties in a transaction is but one consideration, the Board considers the apparent lack of symmetry on a whole-of-system basis may potentially lead to adverse revenue impacts for the Government. More information on this issue in the context of deferred consideration arrangements is in Appendix C.

Key risks identified

3.28 The Board has identified a number of key issues, which it considers may have an adverse revenue impact. These issues are:

(a) The ability to convert capital gains from taxable Australian property into gains from assets that are not taxable Australian property.

(b) The ability to access tax advantages through tax valuations of a right granted (for CGT, UCA etc.) and the subsequent recognition of expenses from that right that is regarded as effectively the same economic outflow.

(c) Issues that arise in the taxation of vendors leading to inappropriate economic outcomes.

3.29 These issues are discussed below, with further detailed analysis provided in Appendix C.

3.30 In particular, in the following analysis different outcomes arise for TOFA and non-TOFA taxpayers. This will be identified where relevant, with further analysis on this matter in Appendix C.

Gains from taxable Australian property

3.31 Australia's non-resident CGT taxation rules appear in Division 855. This Division broadly provides that a foreign resident can disregard a capital gain or loss from a CGT asset that is not taxable Australian property (TAP)[59].

3.32 This definition includes taxable Australian real property (TARP) and indirect taxable Australian real property interests (Indirect TARP), which is narrowly defined[60]. The definition generally includes a membership interest that passes the 'non-portfolio interest test' and the 'principal asset test'.[61]

3.33 An indirect interest in TARP must be a 'membership interest' as defined and as such not all indirect investment interests held by foreign residents will be taxable. The requirement that an indirect interest in TARP must be a membership interest differs from the text of Australia's DTAs which refer variously to shares or comparable interests[62].

---

[59] Section 855-10.
[60] Section 855-25.
[61] Sections 960-195 and 855-30 respectively.
[62] For example, see Article 13 of the *Agreement Between Australia And The Federal Republic Of Germany For The Elimination Of Double Taxation With Respect To Taxes On Income And On Capital And The Prevention Of Fiscal Evasion And Avoidance (2015).*

3.34 In the context of deferred consideration arrangements, and of particular concern to the Board, an instrument (whether equity, debt or contractual) which derives its value and delivers returns calculated by reference to the performance of underlying Australian real property, does not satisfy the definition of Indirect TARP and therefore any capital gain or loss may be disregarded by a foreign resident.

3.35 The Board considers that contractual rights to future financial benefits under deferred consideration arrangements would be unlikely to satisfy the definition of Indirect TARP, and thereby has the potential to effectively convert what would otherwise be capital gains derived from Australian real property into disregarded capital gains for foreign investors.

3.36 Where the underlying property is TARP and subsequent rights do not carry that characterisation, the Board considers that this leads to certain receipts relating to Australian real property not being subject to Australian income tax where received by a foreign resident. This risks distorting commercial transactions, therefore affecting economic efficiency as capital may be deployed where it would otherwise be more efficiently deployed elsewhere. Further, it may adversely impact the equity of the corporate tax system, by providing preferential tax outcomes for foreign investors over resident investors.

3.37 This is also a risk to revenue adequacy if these capital gains and other related income are not taxable under the current tax law, as it will likely lead to corporate tax base erosion.[63]

3.38 The Board is not aware of the extent to which these arrangements are entered into with a view to circumvent the operation of these TARP rules but the outcomes outlined above are an automatic consequence when applying the existing law.

3.39 The Board considers that this requires further consideration as it represents a risk to the general principle that Australia should tax income, profits and gains relating to real property situated in Australia that may exist more broadly. It is noted, however, that the rights reserved under our double tax agreements may limit Australia’s ability to tax such rights.

---

[63] Natural resource income (including payments commonly known as ‘overriding royalties’) may be taxable under section 6CA of the ITAA 1936 and collected under Subdivision 12-G of Schedule 1 of the *Taxation Administration Act 1953* (being the withholding arrangements for ‘payments in respect of mining on aboriginal land, and natural resources’). While payments under deferred consideration arrangements may fall within the scope of these provisions, there is some uncertainty about the scope of these rules more generally (for more information, see draft Taxation Ruling TR 2016/D3 *‘Income tax: application of section 6CA of the Income Tax Assessment Act 1936 and Australia's tax treaties and the payer's withholding obligations’* and associated public commentary). It is unlikely that these provisions apply to gains made on the sale of rights to deferred consideration even if payments pursuant to the right are assessable under section 6CA. Further, deferred consideration arrangements arise in a broad range of industries where these rules would have no application.

3.40 The Board has concluded that, at a minimum, where deferred consideration arrangements relate to underlying Australian real property, the contractual rights to future financial benefits should retain the character of taxable Australian property. This is raised further in the options considered in Part C of this chapter.

OBSERVATION

The Board considers that the ability to use deferred consideration arrangements to convert capital gains and losses from taxable Australian property into gains and losses from assets that are not taxable Australian property presents a revenue risk that should be addressed.

Tax advantages for Purchasers

3.41 The Board has identified that purchasers under certain deferred consideration arrangements can obtain tax advantages which do not reconcile with the economic outflow made under the arrangement. This can include multiple tax recognition for what is regarded as a single economic outflow and tax recognition for an amount where there the taxpayer has ultimately not incurred any economic outflow.

3.42 As outlined earlier in Part B, a corporate tax system ideally reconciles the transactional taxing point and subsequent taxing points to reflect the underlying profit of the parties. The Board considers that this should also be the case for deferred consideration arrangements.

3.43 The Board has however identified that where the future payments made by a purchaser are recurrent and ongoing, they may be of a revenue nature and immediately deductible as incurred. For example, deductible payments include those calculated by reference to the exploitation of underlying property (eg, minerals or intellectual property), contingent on certain targets being achieved (commonly referred to as 'royalties' despite not satisfying its ordinary or legal meaning) and will in many cases be immediately deductible to the purchaser.[64]

3.44 The Board has confirmed stakeholder feedback – purchasers may be able to obtain tax recognition for both the upfront market value of the deferred consideration right taken into account on a transactional tax basis, as well as subsequent deductions for payments made under the right.[65]

[64] See *Cliffs case*.

[65] This may also theoretically apply in the context of the cost of an asset first used for exploration or prospecting for minerals, or quarry materials, obtainable by mining and quarrying operations, that are subject to certain statutory effective life deprecation provisions (sections 40-80 and 40-95). However, the Board is not aware of deferred consideration in this context where the right to future payments has material value.

3.45 While it is not clear to the Board how prevalent this tax outcome has become, it is also not apparent whether stakeholders have considered closely the possibility that purchasers may be taxed on any valuable consideration they receive for granting a deferred consideration arrangement (ie, as a capital gain under CGT event D1 or CGT event D3, considered further below).

3.46 As outlined in Chapter 1, the acquisition and any subsequent payments are currently characterised as distinct legal constructs (ie, the obligation to pay, and the subsequent actual payment under that obligation) and are therefore dealt with separately under the tax law. In practice this means that the only economic outflow (being the subsequent payment of deferred consideration) is recognised twice for tax purposes without regard to the overall economic or commercial outcome for the taxpayer.

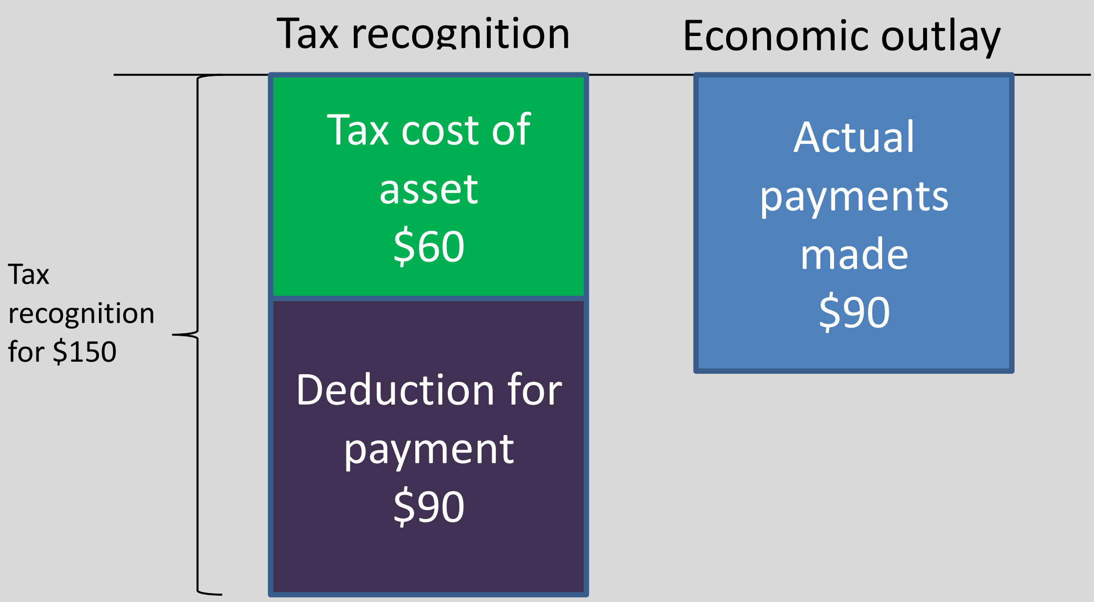
3.47 This is explained in the following diagram.

Diagram 3.1: Tax v Economic Outcomes

Scenario: As part of a transaction to sell a business asset, a purchaser grants a vendor a right to receive a future, uncertain payment of up to $100 in the future if certain hurdles are met. At the time of the grant, the right is valued at $60 and forms part of the tax cost base (which may be depreciable) for the asset.

Where the purchaser subsequently pays $90 to the vendor, the purchaser's overall outcome is tax recognition of $150 for a single economic outflow of $90 (assuming the $90 is deductible).

These outcomes can be displayed graphically as follows (assuming D1 and D3 do not apply):



3.48 Likewise, as commercial parameters change over time, in some deferred consideration arrangements no payments are ever made. There is no mechanism in the tax law to reconcile the upfront value against the subsequent diminution in value – resulting in an effective economic gain made by the purchaser not recognised for tax purposes.[66] That is, a purchaser may obtain a tax advantage for no ultimate economic outlay.

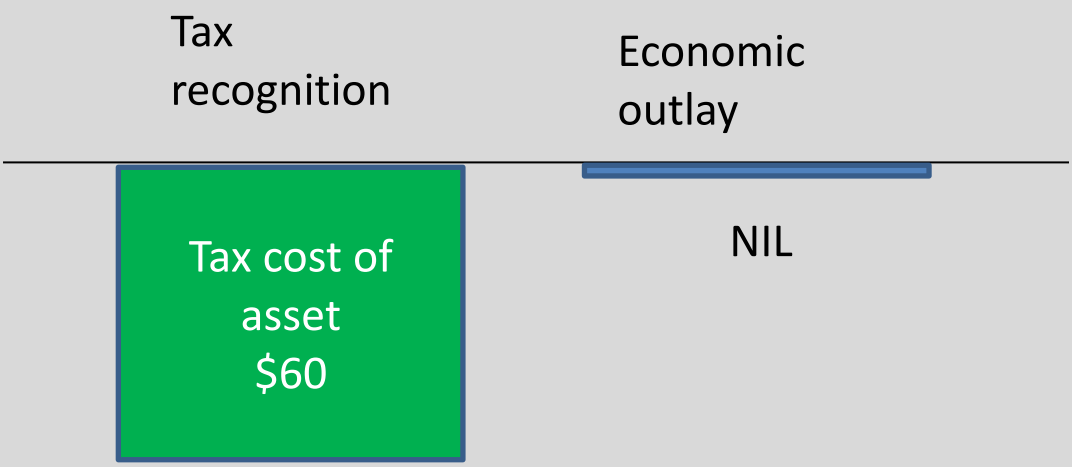
3.49 This is explained in the following diagram.

Diagram 3.2: Tax v Economic Outcomes – nil payments

Scenario: the same as Diagram 3.1, however no payments are ever made under the deferred consideration right as the trigger events are not met.

When the purchaser disposes of the asset, they may receive tax recognition for $60 notwithstanding that there has been <u>no economic outlay</u>. This is because it is possible that the $60 is recognised as the cost base of the asset, and will be deducted from the capital proceeds received on subsequent disposal of that asset.

These outcomes can be displayed graphically as follows (assuming D1 and D3 do not apply):



3.50 Feedback from stakeholders indicates that these transactions are increasing in prevalence, and more commonly relating to operational assets where the rights to receive the deferred consideration have material value. The mismatch that can arise between the tax outcomes obtained by the purchaser and the economic outflow made by the purchaser arise from the ordinary operation of the tax law. Taxpayers do not need to adopt highly structured or contrived arrangements to achieve this outcome. Indeed, the Board was informed that, given the long-dated nature of deferred

[66] For example, this would not be caught by the commercial debt forgiveness provisions.

consideration arrangements, it is possible that purchasers will be unaware of the dual recognition of payments by the time that payments are made. Having said this, informed taxpayers may seek to structure their affairs in a manner which ensures they obtain or optimise the potential advantages achieved from these outcomes.

3.51 It is the Board's view that these consequences occur as a consequence of the application of the existing law, which treats the obligation to provide future financial benefits and the subsequent benefits separately – this interpretation was overwhelmingly confirmed in consultation. Importantly, these benefits can be obtained without manipulation or structuring of an otherwise ordinary commercial transaction.

3.52 However, stakeholders have confirmed that awareness of the potential for these tax advantages is becoming more prominent, and that purchasers may be advised to consider how to maximise tax advantages. For example, purchasers could be encouraged to adopt an aggressive approach to valuation of the obligation to make the future payments of deferred consideration (discussed later in this chapter).

Potential application of CGT events D1 and D3

3.53 As outlined earlier, the Board has some concerns regarding the potential operation CGT events D1 and D3 to deferred consideration arrangements. The legislative provisions of these CGT events are drafted in broad terms and could potentially create upfront cash tax liabilities for purchasers.

3.54 At the transaction taxing point, a vendor will pay CGT on capital gains crystallising upon disposal of their underlying asset. Were these CGT events to apply, a purchaser would also be subject to CGT upfront at the transaction taxing point. This outcome would mean that both parties have paid tax upfront in respect of an uncertain future amount that may never in fact be paid.

3.55 It was suggested to the Board that these provisions may 'neutralise' the tax advantages identified earlier in this chapter. However, the Board considers that, where they may apply, the outcomes achieved by CGT events D1 and D3 can be inappropriate and are likely to stifle commercial activity.

3.56 An upfront tax liability for a purchaser resulting from CGT events D1 or D3 in the circumstances of deferred consideration arrangements where the purchaser is not in receipt of any cash in consideration for the granting of the deferred consideration right is likely to prevent commercial transactions from occurring because purchasers, when necessarily factoring in the tax timing cost to their negotiations with the vendor, will not be amenable to bearing the financial consequences of an upfront cash tax liability when all that has occurred is the acquisition of assets for a cash outflow and the creation of an obligation to make future cash outflows.

3.57 As there is no public ATO guidance on scenarios in which these provisions would be expected to apply to deferred consideration arrangements[67], stakeholders have informed the Board that they do not expect these provisions would apply to many arrangements as currently structured and designed. However, feedback from the ATO suggests these expectations may not be well founded, although the ATO has indicated that these CGT events will not necessarily apply in all circumstances.

3.58 There may be instances of advisers encouraging taxpayers to adopt positions for deferred consideration arrangements in this regard that have a questionable technical basis. In particular, these positions may not reflect due consideration of existing ATO guidance on the potential for a capital gain to arise under CGT events D1 or D3 when a right to deferred consideration is granted. Comments from stakeholders also suggest that there may be views that certain structuring approaches can be adopted to prevent these CGT events from applying. The ATO is not currently aware of many taxpayers raising issues of uncertainty or seeking additional guidance in these circumstances.

3.59 The Board notes that, subject to any clarification by the ATO on the potential application of CGT events D1 or D3, the tax consequences are such that taxpayers would prefer to manage their affairs such that they do not arise to the greatest extent possible. However, the Board would caution advisers against adopting questionable or aggressive approaches with their clients and encourages taxpayers to seek further advice and guidance from the ATO where the tax outcomes are uncertain to avoid future disputes.

3.60 While the Board considers the potential for these CGT events to apply to deferred consideration arrangements requires further examination, the Board does not consider that their potential application addresses the underlying issues that give rise to the tax advantages identified, nor provides appropriate tax outcomes for purchasers either where future payments are made or in isolation (where no payments are made).

Board observation

3.61 The Board considers that there may be some tax outcomes that adversely impact the equity of the corporate tax system, by providing tax advantages to purchasers that are not effectively matched by the outcomes for vendors.

3.62 The Board considers that there may be legitimate tax outcomes that risk economic efficiency because of the misalignment between tax outcomes and the economic/commercial outcomes.

---

[67] The Board notes that the ATO considers that CGT event D1 does not apply to earnouts and reverse earnouts as defined in TR 2007/D10, while these events will not arise in the context of look-through earnout rights under the CGT look-through provisions.

3.63 The Board has formed the view that these tax outcomes are inappropriate and further investigation is warranted to ensure that they are not currently having a negative revenue impact.

OBSERVATION

The Board observes that multiple tax advantages are available in relation to single economic outflows under deferred consideration arrangements in certain circumstances. Similarly, the Board observes that purchasers are able to obtain a tax advantage in circumstances even where no economic outflow is made. Such outcomes may lead to distortions of commercial transactions, reducing economic efficiency and may also have a negative revenue impact, which should be addressed.

3.64 A number of related issues are briefly summarised below and addressed in further detail in Appendix C:

(a) **TOFA:** Should it apply, TOFA may result in a better alignment of the tax and economic outcomes for deferred consideration arrangements as between vendors and purchasers – the potential application of TOFA is uncertain, and in the Board's view purchasers will be unlikely to structure transactions to qualify for TOFA (if they can), particularly where its application would undermine tax advantages which might otherwise apply.

(b) **Black hole expenditure:** Where a purchaser grants a deferred consideration right to a vendor, subsequent payments that are not revenue in nature are not recognised for tax purposes. This means that if the actual economic outflows under the arrangement exceed the upfront market value applied to the right, no tax recognition will be available and these amounts will be 'black hole'. Purchasers who are concerned about the lack of tax recognition for a future economic outflow will be incentivised to maximise their valuation of the right in order to ensure tax recognition via cost base (potentially depreciable cost base).

3.65 These issues are detailed in Appendix C.

Economic outcomes for vendors

3.66 During consultation, the Board also identified inappropriate outcomes for vendors that warrant further consideration. In particular, there was a common view expressed by stakeholders during consultation that vendors were often subject to what was referred to as 'double taxation' when transactions involved deferred consideration.

3.67 Expressed in a different way, in some circumstances the law does not effectively reconcile the vendor's tax position over time with the ultimate economic outcome of the transaction.

3.68 The Board has identified instances where the operation of the law can result in a misalignment of the overall tax outcomes for a vendor with the economic inflows received by the vendor.

3.69 The following table catalogues key scenarios identified.

	Issue	Outcomes
1	Royalty payments *Double taxation*	A vendor recognises and is taxed on the market value of the right to receive royalties at the time of the transaction. Where future royalties are assessable income, vendors may be subject to double taxation (where the CGT anti-overlap rules do not apply) on the same economic inflow.
2	Stranded basis *Upfront Taxation of Amounts Never Received*	Where a vendor does not receive amounts under the deferred consideration right of those amounts are not "capital proceeds" under the Act, the cost base attaching to the right (and which reflects tax previously paid on that right) may not be 'released' until the right comes to an end (known as 'stranded' cost or basis). Upon release, it is a capital loss that requires subsequent capital gains in order to be brought to account.

3.70 These issues arise in a range of circumstances under deferred consideration arrangements that do not qualify for the CGT look-through provisions. They are particularly acute for arrangements where the rights to receive deferred consideration are long-dated or perpetual, as it is unlikely that the cost base will ever be recognised for tax purposes other than by disposal (having been taken into account for the purposes of calculating the capital gain or revenue profit at the time the vendor sold the underlying asset).

3.71 The Board considers that these issues give rise to complex legal interactions and significant uncertainty. Ultimately, they have the potential to distort commercial decisions due to the likelihood of adverse tax outcomes for vendors.

3.72 The Board understands that many vendors currently seek to apply TOFA to determine the tax outcomes for rights to deferred consideration in order to overcome the above mismatches between tax outcomes and economic inflows. That is, taxpayers appear to be 'self-solving' the above issues as they do not arise when TOFA applies to the deferred consideration rights.[68] The Board notes that it is unclear whether any purchasers are adopting TOFA for deferred consideration arrangements (which would lead to asymmetry of outcomes where the tax advantages identified above are utilised by purchasers).

3.73 However, the application of TOFA to deferred consideration arrangements is complex and its ability to apply to the relevant rights may be narrow in practice.[69] As noted above and at Appendix C, discussions with stakeholders and the ATO suggest that there is currently divergence between taxpayers' views on the application of TOFA to these arrangements and that of the ATO.

3.74 The Board considers that these issues can, and should, be addressed concurrently with the above concerns about potential tax advantages for purchasers. This will ensure that any solution achieves symmetry on a whole-of-system basis and limits arbitrage between any differences of tax treatment between vendors and purchasers.

3.75 Further analysis of these issues is in Appendix C.

OBSERVATION

The Board observes that certain adverse tax outcomes may arise for vendors under deferred consideration arrangements. In particular, these tax outcomes include double taxation of amounts characterised as both assessable income and capital proceeds, and circumstances of stranded cost base. These outcomes arise due to significant complexity in the tax law, but may ultimately lead to distortions of commercial transactions or taxpayers entering into questionable structures or legal positions to achieve greater alignment of tax and economic outcomes, all of which should be addressed.

[68] As outlined in Chapter 2, TOFA offsets the cost of the arrangement to be offset against receipts/payments over the term of an arrangement to provide greater alignment between economic and tax outcomes.

[69] A statutory exclusion (section 230-460(13)) excludes financial arrangements arising from certain deferred consideration arrangements from being subject to TOFA – this exclusion is relatively broad.

Valuation issues

3.76 The above matters create differing incentives as between vendors and purchasers in respect of valuations. A purchaser is incentivised to adopt higher valuations for deferred consideration rights due to the resulting tax advantages. A vendor is incentivised to adopt lower valuations for deferred consideration rights to the resulting tax disadvantages. Whilst it may be arguable that it should be possible for a professional valuer to determine a reasonably objective value for a deferred consideration right, which ideally can be adopted by all relevant parties (ie, purchaser, vendor and the ATO), in practice this is highly unlikely given the divergence of views regarding valuation as between the vendor and purchaser that resulted in the deferred consideration right in the first place. Feedback from stakeholders suggests that it is not considered likely that the parties to the transaction would seek or agree a common valuation. To the extent that vendors and purchasers are provided differing professional objective valuations, the Board believes that this is a potential compliance risk which warrants investigation by the ATO.[70]

3.77 The Board considers that these risks are particularly acute in these circumstances due to the very nature of deferred consideration arrangements. They arise as a consequence of a disagreement as to value between the parties to a transaction. Valuation of the deferred consideration right will require not only the formation of a view as to future economic parameters such as price and exchange rates, but will also require an assessment of the likelihood that any contingent parameters will eventuate (eg, production of certain levels of volume, the construction of an asset etc). Each party will hold a different view as to the likelihood of the relevant contingency. Indeed, if that were not the case, there would be no need for the deferred consideration as the parties would be able to agree on the amount of consideration.

3.78 As a consequence, valuation of the relevant rights can be difficult and result in quite genuine differences of valuation as between the vendor and the purchaser as to the value of the deferred consideration right. Given that the valuations applied by both the vendor and the purchaser play a critical part in determining the tax outcomes for transactions involving these arrangements this inevitable scope for difference in valuation will have a compounding impact on the symmetry or otherwise of the resulting tax outcomes.

[70] The challenges of administering valuation matters are not confined to deferred consideration arrangements: see the Inspector-General of Taxation's *Review into the Australian Taxation Office's administration of valuation matters,* dated 19 January 2015 <https://igt.gov.au/publications/reports-of-reviews/>. In particular, the Board notes paragraph 3.70 'The advantage for taxpayers to access a tax concession creates very strong incentives to incur significant valuation costs and to be over-zealous in defending the resulting favourable valuation'.

3.79 Whilst there are many provisions of the tax law which rely on valuations, it is a contentious area with which it is difficult to comply and often a matter of dispute.[71]

3.80 Based on its discussions with stakeholders, the Board is concerned that the potential tax outcomes place additional pressure on valuations of deferred consideration arrangements. Purchasers may adopt a more aggressive valuation of deferred consideration rights (ie, higher valuations), whilst vendors may adopt a more conservative valuations (ie, lower valuations). If left unchecked, this could lead to systemic asymmetrical outcomes as parties have contrasting incentives and no requirement to agree on a valuation.

3.81 Due to the nature of deferred consideration arrangements it may be unrealistic to expect or anticipate that vendors and purchasers will include an agreement on valuation of the deferred consideration rights within the transaction's documents, as it is typically the differences in view as to the value of the underlying business which leads to the use of deferred consideration in the first place. The Board is not aware of any requirement to do so for any relevant purpose.

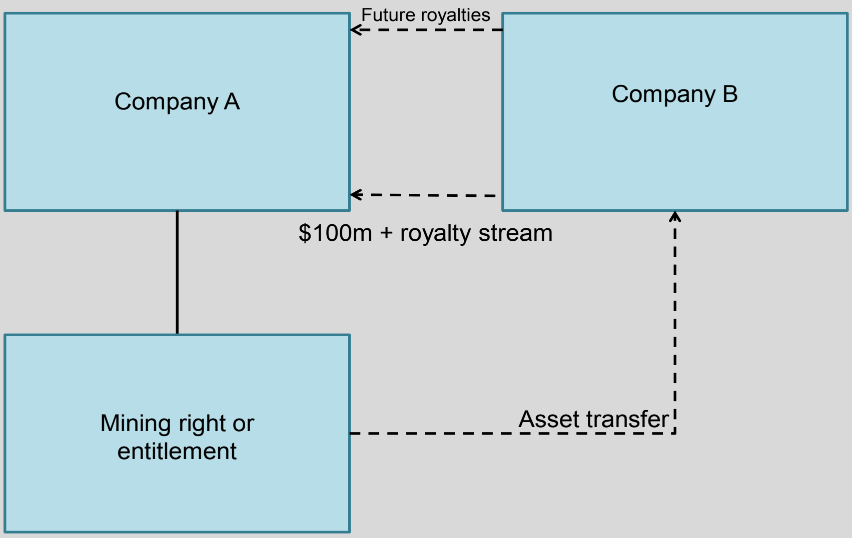
3.82 As noted above, the value of a deferred consideration arrangement will depend of the contingencies embedded in the arrangement, and an assessment of likelihood that these contingencies will be met. It would be expected that for the vendor and purchaser will have different views on the likelihood of contingencies being met, such that both parties could consider their valuation to be accurate based on their assessment contingencies.

3.83 The following case study explores the above issues.

---

[71] For example, see *Resource Capital Fund III LP v Federal Commissioner of Taxation* [2013] FCA 363 and *Resource Capital Fund IV LP v Federal Commissioner of Taxation* [2018] FCA 41.

Case Study 1: Disposal of an undeveloped mining right with a long term royalty



Company A disposed of a CGT asset (a mining right or entitlement) to Company B for $100m cash and entry into a royalty agreement.

Assume the royalty agreement is not a TOFA financial arrangement or an equity interest.

No mine has been constructed, as construction is contingent on obtaining consent from the relevant authorities. The timing of commencement of production is therefore highly uncertain.

The royalty agreement states that a royalty is payable at 2% of the actual revenue on the first 500mt of coal when the index prices exceed US$75/tonne. The value of this income stream is highly contingent and unascertainable.

The royalty agreement is open ended – effectively, it is perpetual depending on future events and will only conclude when the conditions have been met (ie, after the first 500mt of coal has been mined when index prices exceed US$75/tonne).

The vendor values the potential income stream at $30m as at the time of the transaction.

The purchaser takes a different view, with a heightened expectation of the profitability of the asset it has just purchased. The purchaser values its potential series of payments at $70m.

Assume that the purchaser ultimately makes payments under the right of $50m.

Tax consequences

Purchaser Tax Outcomes	Vendor Tax Outcomes
• Depreciating asset cost of $170m depreciable over time (including $70m value of royalty obligations) • Royalty payments of $50m are deductible when paid (deduction incurred for same economic outflow of royalties) • No adjustment to cost base even if nothing is paid (ie, benefit for no outlay) • Total tax recognition of $220m (economic outlay is $150m) • CGT event D1 and D3 may apply (in which case net tax recognition is $150m, which would reflect the purchaser's economic outlay, but with a potential upfront tax cost)	• Capital proceeds of $130m for asset (including $30m value of royalty right) • Royalty receipts of $50m are assessable when received and also $50m of capital proceeds for the royalty right • No capital loss recognised - cost base of right is $30m, capital proceeds of right is $50m (anti -overlap rule reduces capital gain to zero, but does not recognise economic loss) • Total tax recognition of $180m (economic inflow is $150m).

Observations

These outcomes are not symmetrical due to the operation of the law, which may be exacerbated by the different valuations adopted. The tax advantages obtained by the purchaser may be greater than the economic outflows made by the purchaser (while noting the potential impact of D1 and D3 to reduce this difference).

3.84 While noting that professional valuers will seek to their clients with an objective and defensible value for any given asset (such as deferred consideration rights), the Board considers that the above outcomes, including potentially divergent valuations, are possible under the operation of the existing law and valuation principles. However, as noted above, the Board considers that where such outcomes are achieved they are not appropriate as they provide inappropriate incentives for taxpayers to structure their arrangements to access tax advantages, with potentially adverse consequences for economic efficiency. This is exacerbated if taxpayers apply the law with divergent valuations.

3.85 The ATO might wish to consider providing some level of guidance around valuations in respect of these transactions to the extent to which this is feasible given the commercial limitation surrounding these transactions. For example, the ATO could adopt a compliance approach that encourages vendors and purchasers to agree on value (eg, the ATO may be less likely to apply compliance resources where a vendor or purchaser acting at arm's length agree to adopt the same value for tax purposes and the value was determined on an objective basis). –.this may be of particular relevance in the resources sector where a contingency relates to commodity prices if the ATO adopts a compliance approach where the parties use consensus pricing. However, the Board notes that the ATO may be limited in its ability to impose a valuation of one party on the tax affairs of another party.

OBSERVATION

The Board observes that the possibility of differing valuations being adopted by purchaser and vendors under deferred consideration arrangements could exacerbate the other issues identified regarding the lack of tax and economic outcome alignment.

Part C: Options to address concerns

Options considered by the Board

3.86 The Board has considered a number of potential approaches to address the issues identified, ranging from guidance to the formulation of a targeted legislative framework.

3.87 The Board has also considered a number of international comparisons; however, these international measures are generally focused on the vendor. As such these comparisons provided limited assistance. Further information is provided in Appendix C.

ATO guidance and intelligence gathering

3.88 The Board has considered whether the issues identified could be addressed by additional ATO guidance to clarify tax outcomes for deferred consideration arrangements. While the Board's concerns largely relate to matters of policy, rather than administration, any intelligence the ATO may provide on this emerging issue will greatly benefit the Government's decision making process and the public understanding of the ATO's views on the operation of the existing law.

3.89 The Board's observation is that some of the preliminary views expressed by representatives of the ATO during its consultations on the operation of the law and positions being adopted by taxpayers may be divergent, particularly with regards to the potential application of TOFA to deferred consideration arrangements, and CGT events D1 and D3. For more information on these matters, see Appendix C.

3.90 As outlined in Chapter 1, the ATO has withdrawn its draft public ruling on the CGT consequences of certain earnout arrangements following the enactment of the CGT look-through provisions. While the withdrawal notice for the ruling states that the ruling continues to represent the ATO's view for certain deferred consideration arrangements which are outside the scope of the CGT look-through provisions, the withdrawal of this ruling (and the level of legal protection it provides) may have increased taxpayer uncertainty in relation to deferred consideration arrangements more broadly– although it is noted that the ruling was issued before the introduction of the TOFA rules, and did not consider longer-term arrangements or arrangements where future financial benefits were of a revenue nature, and so did not consider their application.

3.91 The Board considers that the existing operation of the law requires additional guidance from the ATO. This is necessary in order to clarify the ATO's view of the operation of the law given the potential divergence of views between taxpayers and advisers, and the ATO.

3.92 Whilst the Board believes this additional guidance is necessary, this may also highlight the tax outcomes available under the current operation of the law with resulting implications for commercial transactions where taxpayers seek to adopt a structured outcome in order to either mitigate concerns which may impact on transaction viability (such as those stemming from the complexity of the law regarding deferred consideration arrangements) or in order to optimise resulting tax advantages.

3.93 The Board therefore recommends that the ATO consider providing additional guidance and increasing its compliance activities in relation to deferred consideration arrangements that are not covered by Subdivision 118-I.

3.94 Notwithstanding the potential for additional guidance to exacerbate the concerns raised in this report, the Board believes that additional guidance will provide further clarity and reduce the likelihood of future disputes over the correct application of the current law. This certainty may provide a greater public understanding of the extent to which there is a lack of alignment between tax and economic outcomes. Further public guidance may also assist to clarify the matters of policy identified by the Board in this report.

RECOMMENDATION 6

The Board recommends that the ATO provide additional public guidance and undertake consultation in relation to the tax treatment of various forms of deferred consideration arrangements that fall outside of the scope of the CGT look-through provisions.

3.95 The Board has identified the risks outlined in this chapter through stakeholder engagement, consultation and publicly available information.

3.96 While the Board acknowledges that there may be difficulties monitoring emerging trends through the use of historical data (ie, tax returns), to the extent that deferred consideration arrangements are increasing (as the Board considers to be the case) in prevalence over time, the ATO may wish to use its information gathering powers or provide further market guidance on risks. For example, requiring deferred consideration arrangements to be disclosed on the Reportable Tax Position Schedule, or seeking taxpayer engagement through industry consultation processes.

RECOMMENDATION 7
The Board recommends that the ATO may wish to consider increasing its information gathering or other compliance activities to improve the Government's understanding of the risks identified in relation to deferred consideration arrangements.

Legislative reform

3.97 The Board considers that the appropriate course of action is to allow the ATO to provide additional guidance and undertake additional compliance activities to consider the extent of the concerns raised by the Board in this report. However, as the Board's concerns largely relate to matters of policy and not administration, the ATO's activities will provide invaluable insight but the Board ultimately expects that the key concerns cannot be addressed by ATO guidance and compliance activities alone and that some form of legislative reform will be necessary.

3.98 The Board has considered the following options to address the concerns identified:

(a) **Option A - targeted legislative reform:** implement a new targeted regime for deferred consideration arrangements that (1) preserves the upfront taxation of the full value of all consideration received by the vendor in respect of a disposal (2) comprises a 'cost-recovery' mechanism to allow vendors to offset receipts against the cost base of the right resulting from its market value on which tax has been paid upfront, (3) provide purchasers with a tax benefit (either deduction or cost base as relevant) only on the payment of amounts under the right**;**

(b) **Option B** – **broader legislative reform**: undertake a holistic review of the design features of the law which are causing tax outcomes to differ from economic outcomes. This may include reviewing the prescriptive nature of the CGT and Division 40 provisions, such as the operation of anti-overlap and double deduction rules and the treatment of gains made from liabilities and obligations;

(c) **Option C - TOFA:** expanding the scope of TOFA to extend to a broader range of deferred consideration arrangements;

(d) **Option D - CGT look-through treatment:** expanding the CGT look-through provisions.

The Board's preferred option

3.99 The Board prefers options for policy change that preserve the underlying scheme of the Act to bring profits to tax on an annualised basis. Modifying the transactional provisions of the income tax law to better align tax and economic outcomes and increase certainty for taxpayers would improve the operation of the tax law. However, the Board has also considered whether any type of concessional treatment (as under the CGT look-through provisions) would be appropriate.

3.100 Ultimately, the Board has concluded that, subject to the outcomes of the ATO's consultation and compliance activities, the preferred solution would be to develop targeted legislative reform to address the issues identified for deferred consideration arrangements (Option A).

3.101 A legislative solution is necessary in order to achieve tax outcomes aligned with the economic flows under the transactions in a manner which does not stifle commercial activity. In the absence of a legislative solution, the potential (but uncertain) operation of existing provisions (such as CGT events D1 and D3) in mitigating the tax advantages of anomalous outcomes is expected to decrease the commercial viability of transactions that adopt these arrangements to bridge the gap in valuation, and would risk stifling commercial activity. The Board is particularly concerned that both a vendor and purchaser will be required to pay tax upfront on an uncertain future amount that may never ultimately be paid (and where tax outcomes might not be reconciled). Whilst it might prevent a purchaser from obtaining tax advantages out of alignment with economic and commercial outcomes, in an overall sense it exacerbates the misalignment rather than providing the solution.

3.102 The Board is also of the view that the Government should undertake a broader holistic review of the design of the law to reduce instances where tax outcomes are not consistent with overall economic and commercial outcomes – this would include the way in which the law operates with regard to the taxation of rights and obligations (Option B). The Board considers that these options are complementary.

3.103 On the basis of the preceding paragraphs, the Board considers that the development of a specific legislative solution should not be delayed by the Option B review, should it be undertaken. By its very nature, it will take time, and the Board would be happy to assist with the review.

3.104 The Board considered a number of options to address some or all of the risks and issues identified. The Board has determined that its preferred approach is Option A, for the reasons set out below.

Option A: Targeted legislative reform

3.105 Subject to feedback which is obtained from the recommended ATO additional guidance and compliance activities, the Board has identified a targeted legislative regime that could address the concerns raised in this report which the Board considers may not be able to be addressed by any ATO additional guidance or compliance activities.

3.106 In the course of its review the Board identified a framework for this potential targeted legislative approach that could address deferred consideration arrangements which do not meet the scope of the look through provisions. That framework has been designed to address the parameters discussed above of asymmetry, uncertainty and complexity, whilst also recognising an imperative to limit any potential revenue cost to the Government.

3.107 Importantly, the Board's approach has been designed to address both vendor and purchaser issues holistically. If a limited solution were to be adopted that only addresses the issues of integrity (ie, tax advantages) identified for purchaser, there may be consequent disadvantages for commerce in general. That is, a one sided fix is not desirable because of the potential to stifle commercial activity – a risk should the outcome fail to facilitate commercial activity with appropriate tax outcomes that do not undermine revenue adequacy.

3.108 The Board considers there would be merit in considering a legislative framework that adopts the following principles:

(a) maintain the current policy framework for transactional regimes (ie, CGT and UCA) to recognise the value of all consideration received by vendors on disposal of assets (by recognising money and the market value of property received as proceeds);

(b) provide for a cost-recovery mechanism which will first offset any subsequent receipts of that character (or crystallise a capital loss of a relevant proportion of the cost base where payments of income – see below) under the right against the cost base the taxpayer has in the right before any further tax is payable on those receipts;[72]

(c) provide for purchasers to only recognise payments as incurred (either cost base or a deduction) under the deferred consideration right;

(d) the existing CGT look-through provisions should apply in priority to this proposed regime;

[72] Similar mechanisms already exist in the tax law (eg, CGT event G1 which reduces the cost base of a share for returns of capital is akin to a cost-recovery mechanism); however, there are a number of ways in which this could be designed.

(e) this regime should apply in priority to TOFA; and

(f) deem the right to receive future financial benefits arising under a deferred consideration arrangement to be TARP where the underlying property was TARP, with a cost base equal to the right's market value at time of grant.[73]

3.109 These principles should address the most significant concerns that the Board has identified, providing tax outcomes consistent with the economic consequences of the transactions and ensure symmetry on a whole of tax system basis. The Board also considers that these principles will provide certainty and will reduce the complexity that is currently implicit in the existing law.

3.110 The Board considers that this proposal should address the issue of 'stranded cost' by allowing vendors to effectively write off the cost of the right against the receipt of amounts under the arrangement. However, consideration should also be given to a mechanism that allows the vendor to crystallise a loss for some or all of the cost where no payments have been, or are expected to be, received under deferred consideration arrangement. The Board considers that the bad debt deduction rules may be illustrative in this regard.

3.111 Whilst a valuation will still be required in order to ascertain the vendor's up front taxation consequences on the disposal, the principles above eliminate the potential for different valuations to be adopted by the parties to the transaction and the resulting risk to the Government revenue resulting from asymmetrical outcomes.

3.112 As the proposal addresses major revenue concerns without adopting the concessionary approach of the CGT look-through provisions, it is the Board's impression that the proposal would be at worst revenue neutral or potentially revenue positive. The Board notes, however, that no revenue costing has been undertaken to confirm this impression.

3.113 The Board notes that there is potential for complexity in this reform in relation to the characterisation of receipts and payments under a deferred consideration arrangement. The Board's view is that the character of payments under general principles should be retained (that is, where amounts paid or received under a deferred consideration arrangement are revenue in nature, they should retain this characterisation). This is based on practical considerations including the potential for a long 'lag' time between the creation of rights and the payments being made and received. The risk involved with artificial characterisation being imposed on payments over an extended period of time is

[73] Deferred consideration rights held on revenue account should be treated analogously, for example by deeming the gains or losses to have an Australian source (for example, consideration could be given to expanding the scope of section 6CA from its current relatively narrow application). The Board understands this to be particularly relevant for TOFA taxpayers where the rights are taxed under TOFA on revenue account. Any such changes would need to consider Australian double tax treaty interactions and limitations.

significant and the Board considers this would pose complexity and integrity issues, the solution to which may outweigh the benefits of the Board's preferred approach. However, should it be necessary to clarify, amounts of income derived under these rights should maintain an Australian source where the underlying sale is of taxable Australian property – further consideration is required for ways in this may be achieved (and any double tax treaty implications).

3.114 A further issue the Board has identified is where either party may be able to opt out of the specific regime in order to pursue a more beneficial tax outcome (eg, for a purchaser to obtain the current law's double tax benefit). It is the Board's view that this regime should have automatic application to both parties should the commercial arrangement meet the conditions that would be set out in the legislation.

3.115 It is the Board's view that such a legislative approach should be adopted only on a holistic basis; that is, addressing both sides of the transaction concurrently. This will have the effect of pre-empting integrity issues in the corporate tax system, while providing better certainty within a complex area of tax law. The Board does not expect a legislative solution to materially increase complexity, and that any complexity is outweighed by the benefits of reducing inefficiency and uncertainty.

3.116 The Board considers that this approach will best resolve the technical problems that arise for deferred consideration arrangements.

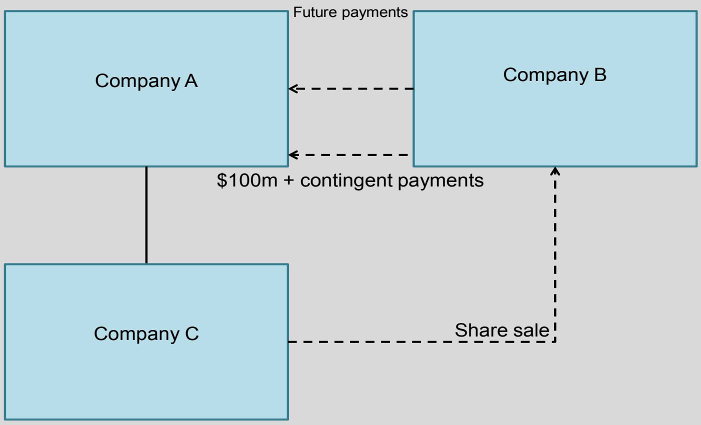
RECOMMENDATION 8

The Board recommends that, following consideration of the outcomes of the ATO's further work, the Government enact a targeted legislative regime for deferred consideration arrangements not covered by Subdivision 118-I, maintaining the general scheme of the Act to tax upfront the value of all proceeds received by a vendor on the disposal of assets, with targeted modifications to eliminate the potential for tax consequences that do not align with economic outcomes.

The Board recommends that further consultation be undertaken on the design of such a regime in line with the principles identified by the Board. This consultation should take into account feedback from the ATO's public guidance and compliance activities.

3.117 The Board recommended outcomes are illustrated by the following case study.

Case Study 2: Disposal of a software development company



Company A disposed of shares in Company C (a software development company) to Company B for $100m cash and up to $40m in contingent payments.

Company B will integrate the underlying technology and IP from Company C into a new online business platform and continent milestone payments are set out in an integration plan developed by Company B.

Assume that the contingent payments are capital in nature and they are not financial arrangements or equity interests.

These contingencies are generally not considered to be contingent on economic performance (such that the transaction will not qualify for the CGT look-through provisions).

The vendor values the right to receive contingent payments at $25m.

The purchaser takes a different view, expecting the vendor is unlikely to meet all of its required milestones and events.

The purchaser values its potential series of payments at $10m.

The following table illustrates the tax outcomes for the purchaser and vendor.

Tax consequences

Scenario	Potential Purchaser Tax Outcomes	Potential Vendor Tax Outcomes
Current outcome	• Cost base of shares $110m • If company B is a tax consolidated group, this will be Step 1 of Allocable Cost Amount calculation • No adjustment to cost base if more or less than value of the right ($10m) is paid • No tax recognition for payments in excess of $10m • CGT event D1 may apply	• Capital proceeds $125m ($100m + $25m value of right) • Receiving an amount under the right or its cessation triggers CGT event C2. • Apportionment of cost base required for each receipt. • Ultimately, capital gain or loss is recognised to extent receipts exceed or fall short of value of the right.
Expected outcome under legislative proposal	• Cost base of shares $100m • Additional payments added to cost base of shares as made. • Analogous changes for tax consolidated groups. • CGT event D1 does not apply	• Capital proceeds of $125m (including $25m value of right) • Recognition of $25m over time against the first $25m of capital receipts (cost-base recovery) • Right taxable Australian property in case of sale

Option B: Broad Legislative reform: a holistic review of the design of the law to more closely align tax and economic outcomes

3.118 A number of the concerns identified by the Board arise as a consequence of issues with the operation of, or absence of, relevant anti-overlap, double counting, and double deduction rules. In particular:

(a) the absence of a rule to prevent duplication of CGT cost base or depreciation cost arising where a purchaser issues a right as consideration for the purchase of a business asset, and subsequent expenditure in satisfaction of the right is deductible for the purchasers resulting in inappropriate outcomes for purchasers;

(b) the absence of a rule to adjust CGT cost base or depreciation cost or recognise a gain from an obligation where a purchaser includes the value of a right granted as consideration for the purchase of a business asset, but does not ultimately incur any expenditure in satisfaction of that right; and

(c) the application of the existing anti-overlap rule to reduce capital gains where subsequent receipts are income for the vendor can result in inappropriate outcomes.

Purchasers

3.119 As outlined earlier in this chapter, purchasers are able to achieve outcomes where the amount recognised for tax purposes exceeds their economic outlay (eg, a tax benefit may be available twice in respect of the same economic outlay or a tax benefit may arise where there is no economic outlay).[74]

3.120 This outcome arises as a result of the absence of a rule to reconcile the amount included in cost base or depreciation cost arising from the issue of the right, with subsequent payments made by the purchaser in satisfaction of that right. Whilst section 110-45 and section 40-215 prevent expenditure that is deductible from being included in CGT cost base or depreciation cost, these provisions do not apply as the payments made in satisfaction of the deferred consideration right are separate from the right itself.

3.121 The Board considers that there should be reconciliation between the upfront value recognised for cost base or depreciation purposes and subsequent deductible payments.

3.122 Where a purchaser does not ultimately incur any expenditure under a deferred consideration right, there may also be no mechanism to adjust the CGT cost base or depreciation cost or otherwise recognised a gain.

---

[74] Refer to Examples 1 and 2 in Appendix C.

Vendors

3.123 In some circumstances there may be actual double taxation where the cost base of a right to deferred consideration is 'wasted' due to the technical application of the CGT 'anti-overlap' rule.[75] This anomaly arises because CGT is assessed on a net basis whereas income is assessed on a gross basis, and the anti-overlap rule fails to recognise this distinction in attempting to reconcile these amounts.

3.124 The operation of these rules effectively prevents any loss recognition for the cost of the right that would, over time, reduce double taxation. The Board considers that this does not reflect the underlying policy principles of the anti-overlap rule and requires rectification. However, the Board is not aware of the prevalence of this issue as stakeholders did not comment on its prevalence during consultation.

3.125 Deferred consideration rights provide a telling example of how the double counting rule does not appropriately reduce double counting to allow for the future recognition of capital losses.

Law reform

3.126 The Board has considered whether amending the double counting rules in CGT and UCA may address some of the issues raised for deferred consideration arrangements (such as the ability to address character and timing mismatches).

3.127 Given the significance of these provisions more broadly to the effective functioning of the income tax system, the Board recognises that there are likely significant consequences as well as potential revenue costs to be considered with such a change. These matters would need to be thoroughly considered as part of a wider review.

3.128 However, in identifying the potential issues associated with deferred consideration arrangements, and subject to the recommended ATO additional guidance and compliance activities, the Board considers that there is an opportunity for the Government to address those concerns while at the same time simplifying the law for the benefit of a broad range of taxpayers and transactions. The Board therefore recommends that the Government conduct a holistic review of certain design features of income tax law with a view to reduce instances in which tax outcomes are not consistent with overall economic and commercial outcomes without a sufficient, and articulate, policy justification.

3.129 The Board acknowledges that implementing such reform is likely to take time. As such, the Board does not consider it appropriate to delay the ATO's work, or targeted legislative reform, regarding deferred consideration arrangements to undertake this review.

---

[75] Section 118-20. Also refer to Example 4 in Annexure C.

RECOMMENDATION 9

The Board recommends that the Government conduct a holistic review of the design of income tax law to reduce instances where tax outcomes are not consistent with overall economic and commercial outcomes

In particular, this should include a review of the prescriptive nature of the CGT and UCA rules (for example, the anti-overlap and double deduction rules). The Board considers that it has identified an opportunity to not only address certain potential anomalies and uncertainties, but also simplify the tax law and prevent similar adverse outcomes arising under other arrangements.

Other Options Considered

3.130 To determine its preferred options, the Board also considered a number of other policy options to address some or all of the identified risks and issues. Whilst the Board prefers Option A, the Board considers the following options to have some merit and enhance the understanding of the Board's preferred option.

Option C: Expansion of TOFA

3.131 The Board considered whether it would be appropriate to expand the TOFA regime to extend to a broader range of deferred consideration arrangements. This would involve a number of potentially complex modifications, including:

(a) expanding the definition of 'financial arrangement';

(b) modifying the carve-out for certain earnout arrangements in section 230-460(13); and

(c) modifying the exclusion for smaller taxpayers in section 230-455 to ensure that deferred consideration arrangements are subject to TOFA regardless of the size of the taxpayer[76].

3.132 The Board does not consider that the expansion of TOFA in this manner is the best response to the issues identified above. As outlined in Chapter 2 and Appendix C, there are a number of complexities with the application of TOFA to deferred consideration arrangements. Those complexities would need to be addressed and are likely to result in significant compliance costs for taxpayers (for example, determining the appropriate methodology for offsetting the cost of a financial arrangement against receipts/payments).

[76] This could be done in a similar manner to the current treatment of qualifying securities with a term of more than 12 months held by smaller taxpayers.

3.133 It is the Board's view that these issues are material and must be addressed for this option to provide certainty. However, it is also acknowledged that these complexities would be difficult to address.

3.134 In addition, there may be unintended consequences of such changes, including with respect to the interaction of TOFA with other provisions of the tax law, which has historically proved challenging.

3.135 The Board also considers that it would not be attractive to taxpayers in the SME market to need to resort to TOFA where they are unable to avail themselves of the CGT look-through provisions.

OBSERVATION

The Board observes that extending the operation of TOFA to deferred consideration arrangements in a similar manner to the treatment of qualifying securities may address the uncertainty and risks identified.

However, the actual application of TOFA is unclear and potentially complex – in particular for SME taxpayers should the CGT look-through provisions not be modified as per Recommendation 2.

Option C: Expanding the CGT look-through provisions

3.136 There was consistent feedback from stakeholders that these issues may be addressed by expanding the CGT look-through provisions to a wider range of deferred consideration arrangements.

3.137 The Board notes the following comments were made by the Government on the expansion of the CGT look-through provisions to depreciating assets during consultation on the CGT look-through provisions in 2015:

> *This measure reflects the May 2010 Press Release and accompanying Treasury Proposal Paper, which limited the earnout measure to the disposal of a business or business assets. Expanding this measure to include depreciating assets could substantially increase the scope and cost of the measure.*[77]

[77] Department of the Treasury, *Summary of feedback from targeted consultation – CGT look through treatment to earnout arrangements*, 23 April 2015 <https://treasury.gov.au/consultation/providing-look-through-cgt-treatment-to-earnout-arrangements/>

3.138 Whilst the Board considers there is some merit in the suggestion of stakeholders, the Board notes the Government's concerns with limiting the cost of the concession. It is also the view of the Board that a concessional approach is not necessary in order to address the anomalies and issues identified in this report, and accordingly, the Board did not analyse this policy option further.

OBSERVATION

The Board observes that extending the operation of CGT look-through provisions would likely increase the cost of the concession. The Board does not consider that a concessionary approach is necessary in order to address the concerns identified.

APPENDIX A: BOARD REVIEW PROCESS AND CONSULTATION

1. During the Board's regular consultation with stakeholders, the Board became aware of stakeholder concerns regarding the income tax treatment of certain arrangements where the consideration for the disposal of assets or a business includes an element of deferred consideration.

2. The Board's stakeholders and consultees noted that payment of deferred consideration is commonly contingent on one or more future conditions (such as events or milestones).

3. Stakeholders informed the Board that there is risk and uncertainty regarding how deferred consideration arrangements are dealt with under the tax law. This is also reflected in the multiple forms of guidance the Commissioner of Taxation has previously released.[78]

4. To address complexity and uncertainty for certain deferred consideration transactions, the Government in 2016 enacted Subdivision 118-I of Part III of the ITAA 1997 (the CGT look-through provisions). These changes targeted transactions understood to be prevalent in the SME market, providing certain tax concessions and simplification benefits for CGT (including small business CGT concession) purposes.

5. Stakeholders advise that deferred consideration transactions have become increasingly prevalent over recent years, not only in the SME market but also in large market transactions. This is also evidenced by a significant increase in ASX announcements regarding transactions involving deferred consideration.

6. Large market transactions are generally not expected to qualify for the CGT look-through provisions. The concessional policy settings of those provisions were specifically designed to be limited in scope with the result that the majority of transactions in the large market will not qualify. In particular, the long dated nature of the majority of deferred consideration arrangements in the large market precludes them from qualifying for the look-through treatment. Stakeholders advise that significant tax risks and uncertainties remain unresolved, and that taxpayers are increasingly turning to

[78] For example, TR 93/15 and TR 2007/D10.

'self-solve' solutions that are perceived to provide the appropriate tax outcomes but with significant uncertainty in relation to whether those outcomes are in accordance with the existing technical provision.

7. Feedback from stakeholders was primarily focussed around what was described as 'double taxation' for vendors. In discussions with stakeholders it also became apparent to the Board that in certain circumstances the current operation of the law can also result in tax outcomes for purchasers which arguably do not align to the underlying economics of the transactions and in some cases result in a lack of symmetry overall to the revenue. A number of examples were cited the same economic outflow will effectively result in a tax benefit twice. In some instances a tax benefit can arise where there is no economic outlay. The result of these scenarios is a lack of symmetry to the revenue in the overall tax outcomes of the transaction. With the increasing prevalence and value of transactions involving deferred consideration arrangements it follows that the prevalence and quantum of these results will also rise.

Issues considered by the Board

8. The Board's review consisted of two work streams.

Limb one

9. A targeted post-implementation review of Subdivision 118-I of Part III of the ITAA 1997, as enacted by Schedule 1 to the Tax and Superannuation Laws Amendment (2015 Measures No. 6) Act 2016:

(a) Examine the operation of the CGT look-through provisions to assess whether they are achieving the desired policy outcomes.

(b) Identify problems (if any) with the operation of the rules as enacted in achieving the intended policy outcomes.

(c) Consider options to address any identified problems, including providing potential recommendations (if any) such as:

(i) non-legislative options to address the operation of the current law in achieving desired policy outcomes; or

(ii) legislative options that may modify the operation of the rules consistent with the intended policy outcomes.

(d) Review the interaction of other provisions (in particular, the consolidation and taxation of financial arrangements regimes) with the CGT look-through provisions.

Limb two

10. A review of the income tax treatment of deferred consideration arrangements that do not qualify for the CGT look-through earnout provisions:

    (a) Analyse examples of increasingly common forms of commercial arrangements involving deferred consideration that do not satisfy the threshold conditions for the CGT look-through provisions, including considering:

    (i) Whether current policy settings remain appropriate having regard to developments in commercial practices;

    (ii) Potential legislative amendments to address tax uncertainties and anomalies associated with deferred consideration arrangements that do not qualify for the CGT look-through earnout provisions; and

    (iii) Non-legislative options available to address stakeholder concerns relating to the taxation of transactions that involve deferred consideration.

Issues not considered by the Board

11. The Board has not considered the indirect tax consequences arising from deferred consideration arrangements, except for those explicitly mentioned in this report.

12. Similarly, except as detailed in this report, the Board has not considered in depth the implications of any of its recommendations or observations on cross-border taxation issues.

Consultation

13. The Board's consultation process has involved:

    - the release of a brief consultation note in August 2017 to invite and facilitate submissions;

    - roundtable consultations with a range of stakeholders; and

    - targeted consultation meetings with a number of key stakeholders.

14. Both limbs of the review were consulted on concurrently.

15. Consultees comprised representatives from organisations that regularly enter into transactions involving deferred consideration, as well as tax practitioners with extensive

experience in advising their clients on such arrangements. The organisations that participated in the consultation meetings are listed in Appendix A.

16. The Board advised consultees that the intention of consultation was as follows:

(a) regarding the first limb, to establish whether the CGT look-through provisions are achieving the intended policy objectives and to identify if there are any weaknesses or unintended consequences relating to the provisions as enacted and administered; and

(b) regarding the second limb, to identify issues that arise in other transactions, the prevalence of these issues and any associated prohibitive tax costs and/or integrity risks or distortions to commercial arrangements.

17. The Board invited consultees to provide written submissions, and received one submission.

18. The Board has considered the issues stakeholders raised in submissions and at the consultation meetings, as well as the views of the members of the working group, Treasury officials and the ATO. However, the Board's recommendations and observations in this report reflect its independent judgment.

19. The Board undertook consultation throughout the project to gain insights from a wide variety of stakeholders. Consultation sessions were held in Sydney, Melbourne, Brisbane and Perth, and also via telephone conference with some stakeholders.

20. The following organisations were represented during consultations:

- Australian Petroleum Production and Exploration Association (APPEA)
- Association of Mining and Exploration Companies
- Business Council of Australia (BCA)
- Law Council of Australia (LCA)
- Law Institute of Victoria
- Minerals Council of Australia (MCA)
- The Tax Institute
- BDO Australia
- Ernst & Young
- Grant Thornton Australia Limited

- Greenwoods & Herbert Smith Freehills Pty Ltd
- King & Wood Mallesons
- KPMG
- Pitcher Partners
- PwC Australia
- Chevron Australia
- ExxonMobil Australia Pty Ltd
- Fortescue Metals Group Limited
- Glencore Australia
- Origin Energy Limited
- Rio Tinto Limited
- South32 Limited
- Woodside Petroleum Limited

APPENDIX B: SUMMARY OF ADDITIONAL FEEDBACK ON SUBDIVISION 118-I

No	Issue	Consultee Feedback	Board observation
1	Revenue asset transactions	A consultee stated that the ATO has issued a PBR (authorisation number 1051199012011) indicating that look-through treatment may also apply to a revenue asset transaction.	This PBR relates to the sale of a medical practice, and has limited commentary relating to Subdivision 118-I. The ruling indicates that the 'Earn out Amount' in the relevant transaction was assessable income and not capital proceeds, and even if the amounts were not assessable income, the arrangement does not meet the conditions for a look-through earnout right in subsection 118-565(1). The Board does not consider that this PBR is indicative of an ATO view that look-through treatment can apply to a revenue asset transaction, and has no information regarding the prevalence of these types of transactions. Further guidance on this issue would be informative only to the extent that these transactions become more prominent.

No	Issue	Consultee Feedback	Board observation
2	Application of GST to earnout arrangements	A question was raised about the appropriate GST treatment for earnout arrangements. Some consultees were unaware whether GST consequences had been considered in design and implementation of the provisions.	The Board understands that the GST treatment is unchanged as it was contemplated during implementation. In particular, it is expected that the treatment would accord with Schedule 5 of GSTR 2000/29, which states that: *"the input tax credit to which you are entitled for a creditable acquisition is attributable to the tax period in which you first know the total amount of consideration for the creditable acquisition to the extent it has not been attributed to an earlier tax period."*
3	Small business CGT concession interaction: Issue 1	A consultee stated that the period of time to access the 15 year exemption and the small business replacement asset rollover were extended for transactions involving look-through earnout rights. The relevant provisions (s152-125(1)(b), s292-100(4)(b) and 104-190(1A)) provide an extended period until 6 month after the final potential benefit under an earnout; however, the *Explanatory Memorandum* at paragraphs 1.113 and 1.115 state the period was extended for 2 years.	The Board expects that this is a typographical error, and that the stakeholders should comply with the law as enacted. The ATO may wish to provide clarity on this in a future guidance product regarding the CGT look-through provisions.
4	Small business CGT concession interaction: Issue 2	Consultees are concerned with the operation of the choice in subsection 152-20(6) of the ITAA 1997 to apply the maximum net asset value test for transactions involving look-through earnout rights.	The Board understands that these comments largely reflect the preference of stakeholders for more guidance on the effect of the choice. The ATO may wish to provide clarity on the operation of the maximum net asset value test in a future guidance product regarding the CGT look-through provisions.

No	Issue	Consultee Feedback	Board observation
5	Active asset test	Some consultees noted that there is more difficulty ensuring that an asset is an active asset at the time of sale (for the purposes of the CGT look-through provisions), compared to satisfying the active asset test for other provisions of the tax law. Currently, small businesses do not constantly monitor the status of their assets as, for the purposes of other provisions, the active asset test applies over a longer period of time and business owners will simply reconcile when accessing the small business concessions. This raised concerns because small businesses have varying levels of active assets. For example, many hold Division 7A compliant loans, which vary in value over time and may at certain times breach the 20% limit in section 118-570 such that the shares in the company would not qualify for CGT look-through treatment. Further, paying out these loans prior to a sale might be considered a scheme to obtain a tax benefit, increasing the risk of general anti-avoidance rules being applied. While some examples exist where such loans are considered active assets (an ATO ID provides one such example), the outcome is not certain.	The Board considers that these tests apply in different ways. The use of the term 'active asset' appears to reflect the point-in-time nature of the tests for look-through earnout rights. Further, where the relevant taxpayer is not a small business, the need to retrospectively consider the active asset test may pose compliance problems. The Board acknowledges that this issue may give rise to an increased compliance burden for small businesses, as they will be required to re-test the status of all of their assets at the time of sale. This is a question of policy. The Board considers that, were the policy reconsidered, this could be addressed through separate tests for small business and other taxpayers. Should the policy not be revisited, the Board considers that safe harbours may be offered by the ATO as a practical compromise.

No	Issue	Consultee Feedback	Board observation
6	Interaction with scrip-for-scrip	A consultee stated that there is no guidance about the interaction of the CGT look-through provisions and CGT roll-overs, in particular, Subdivision 124-M 'scrip-for-scrip' rollover), and that the ATO is reluctant to rule on these issues. There are a number of related issues that have not been explored, including whether provision of shares as financial benefits could qualify as contingent on economic performance, and whether an earnout arrangement could is a 'single arrangement' for the purposes of Subdivision 124-M. In ATO ID 2002/100 (which pre-dated the introduction of the CGT look-through provisions), the ATO indicated that a transaction involving the issue of an undetermined number of shares at a future time was only entitled to partial scrip-for-scrip rollover as the right to receive additional shares in the future is ineligible proceeds for purposes of Subdivision 124-M.	This is a particularly complex interaction issue. The Board considers that it is theoretically possible for a taxpayer to have a right to receive shares in an acquiring company that should satisfy the requirements to be a look-through earnout right. However, this right may be ineligible proceeds under subdivision 124-M. The assistance of general ATO guidance may be limited given the fact-dependent nature of any given transaction. Notwithstanding this, ATO may wish to provide clarity on this in a future guidance product regarding the CGT look-through provisions.
7	Specific rules regarding capital proceeds	A consultee has asked how various capital proceeds rules – including the 'non-receipt rule' in section 116-45 and the 'repaid rule' subsection 116-50(b) – apply in the context of look-through earnout rights. While the specific rules for capital proceeds for transactions involving look-through earnout rights may override the general modifications, the situation is less clear for transactions that do not qualify as look-through earnout rights. The consultee indicated that these modifications might be able to provide a similar outcome to look-through earnout rights if a different view is taken to that adopted by the ATO in TR 2007/D10.	The Board considers that, in the context of the CGT look-through earnout provisions, the operation of the capital proceeds rules are clear. In the context of non-qualifying transactions, the Board considers that the guidance of the ATO on the general operation of the capital proceeds rules is sufficient. The Board notes that the position outlined in TR 2007/D10 continues to be the ATO's view of how the law operates for non-qualifying transactions.

No	Issue	Consultee Feedback	Board observation
8	Tax classification of financial benefits provided and received pursuant to a look-through earnout right	The issue of whether the financial benefits received under a look-through earnout right could be both capital proceeds and assessable income was raised during consultation. Such a situation may arise if royalty-type payments were for a period of up to 5 years. Though not raised during consultation, the treatment of deductible payments made under a look-through earnout right would also be relevant.	The Board understands that the likelihood of this occurring (where a royalty like payment would qualify as a look-through earnout right) is relatively low. It is expected that any such payments would likely be characterised as consideration for the sale of an asset rather than income. As such, while the double counting rule may not always provide an appropriate outcome, the occurrence of such anomalies is unlikely. The treatment of contingent consideration arrangements that fall outside of the CGT look-through provisions, including those that comprise royalty like payments, is considered in Chapter 3 of this report.
9	Other policy issues	Other policy issues that were raised include: • Whether the 20% threshold in the additional active asset test in section 118-570 was appropriate; • The lack of similar look-through provisions in Division 40; and • The five-year limit for look-through earnout rights.	The Board considers that these matters were a deliberate policy limitation of the CGT look-through provisions and are therefore outside the scope of the post-implementation review. The consequences of these scope limitations on transactions which fail to meet the requirements for look through treatment have been addressed in the second limb of this review as a result of stakeholder feedback.

APPENDIX C: DEFERRED CONSIDERATION ANALYSIS

1. The Board has identified that the current tax law can produce outcomes at odds with the underlying economic or commercial outcomes of the transactions and result in a lack of symmetry from a whole-of-system perspective.

2. This section provides further detailed analysis from the Board's consideration of deferred consideration arrangements.

Identified Issues for Purchasers

Tax Benefits Misaligned with Economic Outlays

Multiple Recognition of the same economic outflow

3. In some circumstances, purchasers can obtain a double tax benefit for a single economic outlay (or outlays) under certain deferred consideration arrangements. The double benefit arises in the following circumstances:

   (a) Upon entering into the transaction the market value of the obligation to make future additional payments of consideration (ie the deferred consideration right) to the vendor is included in the cost of the purchased asset for CGT or depreciation purposes (in which case that cost will be depreciable over time).[79]

   (b) Where the payment of those amounts by the purchaser under the deferred consideration right are recurrent and ongoing they may be of a revenue nature and therefore immediately deductible as those payments are made. For example, payments related to the exploitation of the underlying property (eg, minerals or intellectual property) contingent on certain targets being achieved are commonly

[79] Subsection 110-25(2) and section 40-185.

referred to as 'royalties' (despite not meeting the ordinary meaning of the word 'royalty') and will in many cases be immediately deductible to the purchaser.[80]

4. Where the payments under a deferred consideration arrangement are deductible on revenue account, the purchaser gets the benefit of this deduction as those amounts are paid in addition to the value of the obligation to make those payments being reflected in the cost base of the assets acquired.[81]

5. As a consequence, the same economic outflow (the royalty payment) is arguably recognised twice for tax purposes, albeit that the amounts are recognised differently under the tax law (one being the obligation to pay, and the other being the actual payment under that obligation). This outcome does not reconcile with the ultimate economic or commercial outcome for the purchaser. This is illustrated in the simplified example below.

Example 1

As part of a transaction to sell a business asset, a purchaser grants a vendor the right to receive a payment of up to $100 in the future if certain hurdles are met. At the time of the grant, the right is valued at $60.

The relevant business asset is a depreciating asset. Accordingly, the purchaser includes $60 in the cost of the depreciating asset, and depreciates this cost over the effective life of the asset.

The purchaser subsequently pays $90 in total under the deferred consideration right. For the purposes of this example, assume the $90 is deductible to the purchaser on payment under section 8-1 of the ITAA 1997.

Over the effective life of the asset and the term of the arrangement, the purchaser will receive <u>tax recognition for $150 in relation to a total economic outlay of $90</u>. This is because $60 is recognised as the cost of the depreciating asset (and will be deductible under the UCA regime), and an outright deduction of $90 is available for the payment under the deferred consideration right.

6. Subject to the potential application of CGT events D1 or D3, the operation of the law in this way provides an incentive for purchasers to adopt higher valuations for deferred

[80] See *Cliffs case*. It should be noted that the majority of the High Court in that case thought it was inappropriate to describe the payments as deferred payments (consideration) for the shares acquired (see Barwick CJ at 148, Jacobs J at 175 and Murphy J at 176).

[81] This may also theoretically apply in the context of the cost of an asset first used for exploration or prospecting for minerals, or quarry materials, obtainable by mining and quarrying operations, that are subject to certain statutory effective life deprecation provisions (sections 40-80 and 40-95). However, the Board is not aware of deferred consideration in this context where the right to future payments has material value.

consideration rights, and an ancillary compliance risk may arise for the ATO in identifying and valuing these arrangements. The difficulties involved with valuation in respect of these types of arrangements are discussed further below.

7. The application of TOFA to an arrangement in this scenario may result in a better alignment of the tax outcomes to the underlying economic outflows (ie, single recognition) however there is considerable uncertainty as to the circumstances in which TOFA applies to deferred consideration arrangements (noting that TOFA has a general exclusion for earnouts[82]). Arguably where a purchaser anticipates the possibility of this scenario it is not incentivised to structure a transaction to ensure that the TOFA provisions apply or to argue its application. The application of TOFA to deferred consideration arrangements is discussed further below.

Tax benefits arising where there is no economic outflow

8. Where a purchaser grants a deferred consideration right to the vendor, the market value of the obligation to make the future payments of additional consideration is reflected in the cost of the purchased asset for CGT or depreciation purposes. The market valuation of that obligation will be undertaken based on an assessment by the purchaser of the relevant commercial parameters into the future (eg, price, foreign exchange etc) and its view of the likelihood that the relevant contingencies will eventuate (for example a decision to develop the relevant asset) resulting in a payment or payments. Over time, those commercial parameters may change and the payment may never be made. If the purchaser ultimately does not make any payments under the obligation, there is unlikely to be any mechanism in the tax law which will result in a change to the cost of the purchased asset for CGT or depreciation purposes, and the effective economic gain made by the purchaser is not recognised for tax purposes.[83] This is illustrated in the simplified example below.

---

[82] Subsection 230-460(13).

[83] For example, this may not be caught by the commercial debt forgiveness provisions as the obligation to pay under a deferred consideration right would generally not be regarded as a "debt" where both the amount is unascertainable as to amount and time of payment (refer *Marren (Inspector of Taxes) v Ingles* [1980] 3 All ER 95).

Example 2

As part of a transaction to sell a business asset, a purchaser grants a vendor the right to receive a payment of up to $100 in the future if certain hurdles are met. At the time of the grant, the right is valued at $60.

The relevant business asset is a depreciating asset. Accordingly, the purchaser includes $60 as the cost, depreciating this cost over the effective life.

No payments are ever made under the deferred consideration right as the trigger events are not met. When the purchaser disposes of the asset, they will receive tax recognition for $60 notwithstanding that there has been <u>no economic outlay</u>. This is because $60 is recognised as the cost base of the asset, and will be deducted from the capital proceeds received on subsequent disposal of that asset.

9. Once again, in this scenario a purchaser may benefit from an aggressive approach to valuation of the obligation to make the future payments of deferred consideration.

10. The application of TOFA to an arrangement in this scenario may result in a better alignment of the tax outcomes to the underlying economic outflows (reversal of the tax benefit where no payment is actually made); however, there is considerable uncertainty as to the circumstances in which TOFA applies to deferred consideration arrangements. Once again, arguably where a purchaser anticipates the possibility of this scenario (and adopts the position that CGT event D1 or D3 does not result in a capital gain) it is not incentivised to structure a transaction to ensure that the TOFA provisions apply or to argue its application.

No tax recognition for an economic outflow

11. Conversely, based on the ATO's current approach, a purchaser that grants a deferred consideration right to a vendor can receive no tax recognition for an economic outlay where the future payments of additional consideration exceed the value placed on the obligation to make those future payments of deferred consideration (ie, the deferred consideration right) at the time of entering into the transaction. This scenario will arise where the future payments of additional consideration are not considered to be on revenue account for tax purposes (contrasted with the 'royalty' scenario outlined above) and where the quantum of the payments ultimately made exceed the value placed on the obligation to make those payments up front.

12. The value placed on the obligation to make the future additional payments of consideration will form part of the cost base of the assets acquired but there is no mechanism under the current tax law to reconcile the value of the obligation to make

the future payments and the quantum of the future payments actually made. As a consequence, any payments made in excess of the original value placed on the right will not receive any tax recognition (i.e. true 'black-hole' costs).[84] This results in a misalignment of the tax outcomes to the economic outlays, as illustrated in the simplified example below.

Example 3

As part of a transaction to sell a business asset, a purchaser grants a vendor the right to receive a payment of up to $100 in the future if certain hurdles are met. At the time of the grant, the right is valued at $60.

The relevant business asset is a depreciating asset. Accordingly, the purchaser includes $60 as the cost of the depreciating asset, and depreciates this cost over the effective life of the asset.

The purchaser subsequently pays $90 under the deferred consideration right. For the purposes of this example, assume the $90 is not deductible to the purchaser on payment under section 8-1 of the ITAA 1997. No other provision operates to give the purchaser tax recognition for the amount paid.

Over the effective life of the asset and the term of the arrangement, the purchaser will receive <u>tax recognition for $60 in relation to a total economic outlay of $90</u>. This is because $60 is recognised as the cost of the depreciating asset (and will be deductible under the UCA regime), and there is no mechanism to reconcile the amount paid with the initial value of the right.

13. An exception to this outcome will be where TOFA applies to the deferred consideration arrangement. Where a purchaser experiences this outcome they will be incentivised to seek the reconciliation of the additional payments made against the originally value provided by the operation of the TOFA provisions. As noted in this report, there is significant uncertainty as to the application of TOFA to deferred consideration arrangements.

14. Again under this scenario a purchaser will be incentivised to place higher valuations on the obligation to make future payments under the deferred consideration arrangement.

---

[84] Although section 40-880 allows some recognition of expenditure which would otherwise not be recognised for tax purposes, it does not cover expenditure that is "in relation to a lease or other legal or equitable right" (paragraph 40-880(5)(d)).

Potential Upfront CGT Event resulting in Cash Tax Cost to Purchasers

15. The ATO has indicated that in certain circumstances the granting of a deferred consideration right by a purchaser will trigger CGT event D1 or D3 for the purchaser, resulting in an upfront cash tax cost. This upfront cash tax cost arises in circumstances where the purchaser has not received any cash but rather has acquired assets in exchange for it making a payment to the vendor and agreeing to make future payments of consideration under the deferred consideration arrangement.

16. Stakeholders did not raise the incidence of these CGT events with the Board. When raised by the Board in consultation stakeholders generally expressed views that the operation of these CGT events to deferred consideration arrangements is extremely limited. However, based on feedback from the ATO, the application of these events is potentially very broad, and during consultation it became apparent that there may be a divergence of views about the circumstances in which these CGT events could apply. The Board understands that the ATO is considering this issue, but has noted to the Board that it would be dependent on the particular facts and circumstances and that these CGT events would apply to some deferred consideration arrangements but not to others. This creates the potential for different tax outcomes for what may be perceived by stakeholders as economically or commercially similar transactions.

17. Where one of these CGT events occurs on the creation of a deferred consideration right the tax outcome could be said in some circumstances to rectify any asymmetry of tax outcomes or misalignment to the economic outlays as outlined above. For example, in a scenario where a purchaser could benefit from multiple tax recognition of the same economic outflow, the operation of one of these CGT events could act as a counterpoint to offset the duplicated tax benefit. However, the timing of the tax events arguably misaligns the financial consequences for the purchaser, as the purchaser may have to pay cash tax up-front in respect of the acquisition of an asset (albeit an acquisition of a valuable asset that the purchaser has acquired for no up-front cash outlay).

18. For example, a purchaser values the obligation to make future payments of additional consideration under the deferred consideration right at $100. Where CGT event D1 applies, the purchaser will be liable to tax upfront on $100. The purchaser will add $100 to its cost base in the asset and will therefore receive a tax benefit in respect of that tax base when/if it sells the asset (which could be considerably into the future or potentially never). If we assume that the purchaser ultimately makes a number of future payments which total $100, to the extent to which those payment are deductible on revenue account it will claim a deduction as those payments are made. As a consequence whilst one could argue that the aggregate tax outcomes over time align with the economic outflows, the timing of the tax events does not align with the timing of those outflows.

19. The Board considers the risk of inappropriate upfront cash tax outcomes were these CGT events to apply to deferred consideration arrangements requires further examination. Stakeholders informed the Board that this would likely prevent transactions from proceeding or lead to significant commercial distortions. As purchasers would be subject

to an upfront tax liability at the time of purchase, this outcome has the potential to prevent transactions proceeding as it is not aligned with the economic outcomes or cash flows of purchasers. An upfront tax liability increases the transaction costs, and may adversely impact on transactions clearing the 'hurdle rate' (ie, the rate of return required on an investment).

20. Given these adverse outcomes, and as noted in Chapter 3, the Board is also aware that taxpayers may seek to structure transactions in a manner intended to defeat the operation of these provisions. This creates further potential risk, uncertainty and complexity as well as increased likelihood of disputes.

Identified Issues for Vendors

Misalignment of Tax Recognition with Economic inflows

21. There was a common view expressed by stakeholders during consultation that vendors were often subject to what was referred to as 'double taxation' when transactions involved deferred consideration. Expressed in a different way, in some circumstances the law does not effectively reconcile the taxpayer's tax position over time with the ultimate economic outcome of the transaction.

22. The Board has identified instances where the operation of the law can result in a misalignment of the overall tax outcomes for a vendor with the overall economic or commercial outcomes for the vendor.

23. These instances can arise where:

(a) Upon entering into the transaction, the market value of the right to receive future additional payments of consideration is included in the proceeds of the asset for CGT or depreciation purposes and subject to tax accordingly.[85]

(b) Future amounts of additional consideration received by the vendor which are of a 'royalty' nature (as outlined above) may be assessable as ordinary income.[86]

(c) The vendor will ultimately receive tax recognition from the release of the cost base attaching to the deferred consideration right in the form of a capital loss when the right ends, or is disposed of.

24. Whilst this issue is most acute where the future receipts are assessable as ordinary income, stakeholders also raised concerns in scenarios where the receipts are on capital

---

[85] Subsections 116-20(1) and 40-305(1).

[86] See *Ivanac case*.

account, while the release of the cost base attaching to the right is apportioned resulting in additional taxation on the amounts received even where the sum of those payments have not exceeded the amount originally brought to account and taxed as the value of the right to receive those payments. This brings forward the incidence of the second payment of tax.

25. The Board acknowledges that the amount brought to tax as proceeds relating to the disposal of the underlying asset will form the CGT cost base of the deferred consideration right, which is a separate CGT asset in the hands of the vendor which can be recognised on occurrence of a subsequent CGT event (for example, CGT event C2 on the cessation of the right, or CGT event A1 on the transfer of the right).

26. However, consultees also noted what was referred to as 'effective double taxation' in cases involving long-dated and perpetual deferred consideration arrangements as they may never crystallise any loss for tax purposes (known as 'stranded' or 'trapped' cost or basis).

27. In addition to the stranded cost issue outlined above, in some circumstances there may be actual double taxation where the cost base of the right is 'wasted' due to the technical application of the CGT 'double counting' rule.[87]

28. Where assessable royalty receipts are captured as capital proceeds for a CGT event (for example, CGT event C2 on cessation or partial cessation of a right), the double counting rule reduces a capital gain to the extent an amount is included in assessable income. It does not, however, prevent those receipts from being capital proceeds, with the effect that cost base is 'wasted' against the capital proceeds, and no capital loss can ever crystallise in relation to the right. This leads to effective double taxation of a single economic gain.

29. This is highlighted in the simplified example below.

[87] Section 118-20.

Example 4

As part of a transaction to sell a business asset, a vendor is granted a right to receive a payment of up to $100 in the future if certain hurdles are met. At the time of the grant, the right is valued at $60. The vendor includes $60 as capital proceeds for disposal of the business asset, resulting in a separate asset comprising the right to receive a contingent payment with a cost base of $60

The vendor subsequently receives $90 under the deferred consideration right. For the purposes of this example, assume the $90 is income in the hands of the vendor and also capital proceeds in relation to CGT event C2.

The following tax consequences arise on receipt of the $90:

- The vendor is assessable on $90 as ordinary income
- CGT event C2 occurs as a result of the cessation of the right. A capital gain of $30 arises under CGT event C2 ($90 capital proceeds less $60 cost base).
- Section 118-20 should apply to reduce the capital gain to nil.

Whilst the vendor is not subject to tax on the capital gain, the cost base of the right has been wasted against the capital proceeds, such that it no longer has the ability to recognise a capital loss in relation to the cost base of the right.

In summary, <u>the vendor has recognised a total of $150 for tax purposes in relation to an economic inflow of $90</u>. This is because the vendor has now included $60 as capital proceeds for disposal of the business asset, and paid tax on the receipt of $90 as ordinary income, with no additional relief available for the $60 cost base of the right.

30. The outcomes described above may provide an incentive for vendors to adopt lower valuations for deferred consideration rights. When considered in conjunction with the incentive for purchasers to adopt higher valuations, this can result in asymmetrical outcomes.

Upfront Taxation of Amounts Never Received

31. Stakeholders also raised a concern with the upfront taxation of the value of the deferred consideration right notwithstanding the fact that no amount may ever be received.

32. In these instances, the vendor would be entitled to a capital loss in respect of the cost base of the right at the time the right ceases or is disposed of. Stakeholders did however raise multiple concerns with this:

(a) The loss will be a capital loss and would require a capital gain to arise in order to be of value. In some cases, depending on the nature of the vendor's business activities, this may render the loss useless;

(b) The loss may arise significantly into the future as compared with the tax that is paid upfront on entering into the transaction, with no ability to carry back the loss to offset it against the upfront gain; and

(c) The right may be perpetual and therefore the loss may never arise if the right cannot be considered to have ceased or terminated.

33. The inability to crystallise 'stranded cost' arises in other areas of tax law; however, it is particularly acute for vendors under these types of deferred consideration arrangements. Further consideration could be given as to whether it is appropriate to provide some recognition for stranded cost in these scenarios, noting that it would be a policy departure from other similar scenarios under the law where these issues could arise.

34. This outcome provides an incentive for vendors to adopt lower valuations for deferred consideration rights. When considered in conjunction with the incentive for purchasers to adopt higher valuations, this can result in asymmetrical outcomes.

Use of TOFA to mitigate issues

35. During consultation, stakeholders noted that many vendors are applying TOFA to deferred consideration arrangements to address what they refer to as the 'double taxation' issue outlined above. As outlined in Chapter 2, the TOFA rules allow the cost of the arrangement to be offset against receipts/payments over the term of an arrangement to provide greater alignment between economic and tax outcomes.

36. The Board understands that if TOFA applies to these arrangements, it may address some of the issues outlined above. However, the application of TOFA to deferred consideration arrangements is challenging and may be limited. For example, a statutory exclusion[88] may apply to exclude deferred consideration arrangements from TOFA – this exclusion is relatively broad, and as such TOFA may not apply to many transactions of which the Board has been made aware.

37. The Board further understands that the ATO's preliminary view is that the application of TOFA to deferred consideration arrangements linked to the financial performance of a business or business assets is limited. Members of the Working Group are of the view that this may not accord with developing industry practice. The Board considers that

[88] Subsection 230-460(13).

further ATO guidance on the operation of TOFA to these arrangements would improve industry's understanding of the relevant tax risks, although the ATO has noted that the operation of TOFA will depend on the specific facts and circumstances of the relevant deferred consideration arrangement.

38. The Board also notes that it is unclear whether any purchasers are adopting TOFA for deferred consideration arrangements. As noted above, tax outcomes for purchasers in certain circumstances may incentivise purchasers to prefer a non-TOFA outcome. Contrast this to the above where a vendor is likely to be incentivised to prefer a TOFA outcome. This misalignment increases the possibility of asymmetrical outcomes from a whole of tax system view.

39. The ability to utilise TOFA to mitigate the issues outlined above is limited for taxpayers in the SME market that may be broadly excluded from TOFA due to their size. For these taxpayers, TOFA could only be applied to deferred consideration arrangements that do fall within the scope of the CGT look-through provisions where the taxpayer has 'opted-in' to Division 230, which has broader ramifications for all financial arrangements held by the taxpayer and is likely to add significant compliance costs and complexity. As a result, SME taxpayers cannot fit within the CGT look-through provisions may have fewer options to 'self-solve' for the above concerns in a practical sense.

Lack of symmetry and distortion of commercial outcomes

40. The issues identified by the Board can be summarised under two broad themes – potential for misalignment of tax outcomes to economic consequences resulting in a lack of symmetry on a whole-of-system basis, and the potential for tax to distort commercial outcomes.

41. The application of the current law to deferred consideration arrangements that do not qualify for CGT look-through treatment can lead to a lack of symmetry on a whole-of-system basis for these arrangements. Whilst the Board acknowledges that symmetry between two parties in a transaction is not necessarily a required outcome under the Act, a lack of symmetry on a whole-of-system basis can lead to revenue leakage for the Government. A lack of symmetry on a whole-of-system basis can arise under the ordinary application of the Act and will be exacerbated by the incentives to value rights differently, in conjunction with differences in the characterisation of payments and differences in view of the potential application of TOFA.

42. Similarly, tax outcomes for deferred consideration arrangements can distort commercial outcomes as vendors and purchasers seek to structure arrangements to achieve specific tax outcomes. In this respect, some of the issues highlighted above – for example, the

potential application of CGT event D1 or D3 for purchasers, and the risk of double taxation for vendors – have a greater potential to result in distortions than others.

Debt/equity consequences

43. The Board has analysed whether deferred consideration arrangements are likely to be characterised as equity interests.

44. Some deferred consideration arrangements may include contingencies which may be effectively perpetual (in that they have no fixed end date) – for example, where an amount is payable upon regulatory approvals but there is no time period within which it must be achieved).

45. The Board considers that these arrangements will not generally result in an ongoing equity interest by the vendor in the disposed assets, and do not include rights to vote, dividends, or capital distributions (eg, on winding up). As these arrangements are not entered into to provide finance to the purchaser, they would not meet the definition of equity interest for tax purposes (as discussed in Chapter 1). This does, however, bring into question whether the grant of a deferred consideration right by a purchaser can be excluded from the application of CGT event D1 (which does not apply to borrowing money or obtaining credit or the issue of an equity interest, both of which involve an element of providing finance).[89]

46. The Board notes that there are commercial arrangements which involve vendors maintaining equity interests in sold assets or businesses. However, these transactions are not the type of arrangements to which this review applies.

47. For completeness, the Board has also not analysed arrangements which merely involve an 'effectively non-contingent obligation' on the purchaser to provide additional payment (ie, debt or vendor finance).

International comparisons

48. The Board has undertaken a targeted review of certain international comparisons based on publicly available information, including the relevant law and published guidance from the revenue authorities.

[89] Refer subsection 104-35(5).

United States of America

49. Under the United States Code of Federal Regulations, Regulation 26 CFR 15a.453-1[90], a range of methods are available for taxpayers to account for contingent payment sales of real property and personal property (ie, to vendors).

50. A "contingent payment sale" is reported under the instalment method, and is defined as the sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs. Specific exclusions apply for retained interests in property such as equity interests, as well as those where the payments are in the nature of rent or royalty income.

51. Broadly, there are three cascading mechanisms by which the basis may be spread across the term of deferred consideration arrangements. These are a gross profit ratio split[91] where the maximum price can be determined, an equal spread across the fixed term if identifiable, or a 15 year equal spread if no term.

52. There is also a mechanism similar to the Board's preferred legislative reform approach that requires the seller to recognise an upfront gain of the fair value of the contingent consideration and then any future gain or loss is calculated should the ultimate consideration differ.

United Kingdom

53. Her Majesty's Revenue and Customs (HMRC) Capital Gains Tax Manual (section CG14850P) deals with all forms of deferred consideration.[92]

54. Where the amount of deferred consideration is ascertainable, the full amount is included in the disposal proceeds (ie, capital proceeds). There are no tax consequences when the future amounts are received.

55. With regards to the types of deferred consideration arrangements considered in Chapter 3 of this report, the Manual sets out treatment for 'unascertainable receipts'.

56. Where the amount of deferred consideration is unascertainable, the value of the right to receive the future payments is included in the consideration for the disposal. Subsequent receipts are treated proceeds for the disposal or part-disposal of the right to

---

[90] United States Code of Federal Regulations, Regulation 26 CFR 15a.453-1, *Installment method reporting for sales of real property and casual sales of personal property*, https://www.law.cornell.edu/cfr/text/26/15a.453-1 last accessed June 2018

[91] The gross profit ratio is calculated as gross profit / contract price, with gross profit worked out as selling price less basis in the property.

[92] Her Majesty's Revenue and Customs, *Capital Gains Tax Manual (Section CG14850P)*, https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg14850p last accessed June 2018

receive the future payments. The acquisition cost of the right (ie, the cost base) is either the original market value, or for a series of receipts each part-disposal at each date is ascertained using a 'part-disposal formula'.

Canada

57. Under the Canada Revenue Agency's (CRA) Income Tax Ruling IT-426R Shares Sold Subject to an Earnout Agreement[93], vendors may adopt the cost recovery method of reporting capital gain or capital losses on the sale of shares subject to an earnout agreement.

58. The cost recovery method is available where:

    (a) The vendor and purchaser are dealing with each other at arm's length.

    (b) The gain or loss on the sale of shares of the capital stock of a corporation is clearly of a capital nature.

    (c) 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.

    (d) The earnout feature in the sale agreement must end no later than 5 years after the date of the end of the taxation year of the corporation (whose shares are sold) in which the shares are sold. For the purposes of this condition, the CRA considers that an earnout feature in a sale agreement ends at the time the last contingent amount may become payable pursuant to the sale agreement.

    (e) The vendor submits, with his return of income for the year in which the shares were disposed of, a copy of the sale agreement. He also submits with that return a letter requesting the application of the cost recovery method to the sale, and an undertaking to follow the procedure of reporting the gain or loss on the sale under the cost recovery method as outlined below.

    (f) The vendor is a person resident in Canada for the purpose of the Act.

59. The cost recovery method applies to the vendor by reducing the adjusted cost base of the shares as amounts on account of the sale price become determinable. Once the payments exceed the cost base, excess amounts are recognised as capital gains realised when derived and the cost base becomes nil.

---

[93] Canada Revenue Agency, *Income Tax Ruling IT-426R Shares Sold Subject to an Earnout Agreement*, dated September 28 2004 https://www.canada.ca/content/dam/cra-arc/formspubs/pub/it426r/it426r-e.pdf last accessed June 2018

60. The vendor may also recognise a loss only once it is irrevocably established that the maximum potential amount will be less than the vendor’s adjusted cost base. If there is no maximum cap, the loss can only be recognised once it is established that the total of all amounts payable cannot exceed the cost base.