Law Council OF AUSTRALIA

Business Law Section

Law Design Practice
The Treasury
Langton Crescent
PARKES ACT 2600
Via email: taxlawdesign@treasury.gov.au

22 May 2015

Attention: Mr Patrick Boyd

Dear Mr Boyd

CGT treatment of earnout arrangements – Exposure draft

The Taxation Committee of the Business Law Section of the Law Council of Australia (the Committee) thanks Treasury for our confidential involvement in consultation on the draft Exposure Draft prior to its public release on 23 April 2015.

We refer to our submission dated 13 February 2015 in this regard.

That said, other than the amendment to now introduce transitional rules to protect taxpayers that entered into arrangements prior to 23 April 2015 (which the Committee supports), we are largely disappointed with the lack of any further amendments to address the many issues we consider remain.

We submit that this proposed drafting unnecessarily limits the look through treatment of earnouts to a small range of arrangements.

We note that, as outlined at paragraph 1.22 of the draft Explanatory Materials, it appears that Treasury may have decided to pursue this narrow approach due to 'policy considerations'.

We submit that the approach should be to ensure that the tax law works to support commercial arrangements, not to act as an inhibitor. Rather than a view, as clearly expressed in the draft Explanatory Materials, that there is a risk of deferral of taxation liability, there should be a view that a lack of look through earnout treatment can give rise to taxation liabilities (which require cash funding) to arise where taxpayers are not provided with cash to meet their obligations.

In this regard, we refer again to our 13 February 2015 submission and request that our views on various aspects which may be regarded as a matter of policy (for example, limiting the look through treatment to only CGT event A1 transactions, to only 4 year arrangements and to 'active assets') be reconsidered.

In light of the economic climate and uncertainties around global economies, industries, currencies and political stability, the use of earnouts in M&A transactions are more important than ever. We

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submit that the policy consideration should be to facilitate commercial dealings rather than to stifle activity.

We further note that, in addition to items we made recommendations on that may be considered policy matters, there are other matters that should not be regarded as policy issues and should be addressed. For example, as outlined in our 13 February 2015 submission:

- the application of the look through treatment only to Australian resident entities does not appear to be a matter which causes any risk to the Revenue;

- the requirement to continually amend prior tax returns needs to be reconsidered. While the approach to not charge interest is supported, there remains the compliance burden and cost with continued amendments of the return not only for the year in which the right arose but likely also the tax returns for each and every subsequent year as they are likely to be affected by the original year; and

- the asymmetry between losses only being able to arise at the end of the arrangement (or earlier only if the 'certain' maximum amount is reached under paragraph 118-580(2)(a)) compared with gains having to be included in the original tax return through amendment of assessments does not appear to be a matter which causes any risk to the Revenue (in fact, seems to be an unfair outcome for taxpayers).

If this approach of introducing a detailed and narrow definition of a look through earnout right (i.e. the lengthy definition in section 118-565) is adopted (against our recommendations), we note that there are issues with the current drafting in a number of areas, for example:

- On what basis is it to be determined that financial benefits are not 'reasonably ascertainable'? No detail is provided in either the Exposure Draft or Explanatory Material on how this is to be applied.

- How is a mining company's failure to find a mineral resource (as an example) not a matter which affects the 'economic performance' of the company? While this position is made in the Explanatory Material, we note that the language in paragraph 118-565(1)(f) does not require a *direct* connection.

- How does paragraph 118-565(1)(f) apply to the acquisition of shares in a company (**Target Company**) or target assets (**Target Assets**) by a larger group (**Acquirer Group**) where the vendors receive an earnout right which is based on the performance of the broader Acquirer Group? Is paragraph (f) to be read as applying only to earnouts that are directly calculated by reference to *only* that Target Company/Target Asset's performance? This would not align with commercial arrangements where acquisitions of assets and entities are often undertaken on the basis that synergies/efficiencies/size improve economic performance.

- We submit that there is considerable ambiguity around the expression *until 4 years after such a *lookthrough earnout right expires* in both subsections 112-36(3) and 116-120(3). It appears from the Explanatory Materials that the intention is for this to refer to '4 years after the last financial benefit is payable under the lookthrough earnout right'. However, there is a clear possibility to read the words of the proposed provisions (without regard to the Explanatory Materials, which would only be relevant where there is difficulty in ascertaining the meaning of the relevant provision – refer *Peabody v FCT* (1992) 24 ATR 58 at 67) to refer to the expiry of the term of the *lookthrough earnout right – that is 'no more than 4 years after the right is created'. We recommend that this be addressed.

- It is unclear why the time period in which the Commissioner is able to amend an assessment is proposed to be extended to four years from the expiry of the earnout right, however the same extension of period does not apply to the relevant taxpayer. That is, the period in which a taxpayer is entitled to raise an objection requires amendment on the same basis to ensure there is no asymmetry of treatment.

- In relation to this extended period, it is also unclear why the assessment period is not determined by reference to the end of the relevant financial year or the lodgement/due date of the tax return in respect of the relevant financial year. It seems odd, relative to other areas of the tax law, that this amendment is not drafted by reference to the financial year in which the specified event occurs.

- When interpreting the requirement in paragraph (f) of the definition of lookthrough earnout right in section 118-565, do the *financial benefits* have to be contingent on the *economic performance* of either solely the sold asset (in item (i)) or in a *business* which uses the CGT asset and nothing else (in item (ii))? That is, what reading is to be taken of paragraph (f) where an asset is disposed and an earnout is to be calculated by reference to the asset sold and something else? This will be of particular relevance where the asset (which could include shares in a company) are sold into a broader group structure in which the acquirer sits and the earnout is to be calculated on the performance of the acquirer's broader group. This will be common in practice as acquisitions are often undertaken with the object of obtaining synergies post acquisition with other operations conducted by an acquirer.

We request that further thought be given to both the broader policy considerations and the drafting detail (refer, in particular, the above examples) affecting the Exposure Draft.

The Committee would be happy to provide further assistance, or discuss any of the above proposals, if that would assist Treasury. In the first instance please contact Committee Chair, Mr Adrian Varrasso on 03 8608 2483 (email. adrian.varrasso@minterellison.com).

Yours sincerely

John Keeves, Chairman
Business Law Section