

# ***TR 2007/D10 - Income tax: capital gains: capital gains tax consequences of earnout arrangements***



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This document has changed over time. This is a consolidated version of the ruling which was published on *17 October 2007*



## Draft Taxation Ruling

### Income tax: capital gains: capital gains tax consequences of earnout arrangements

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**❶ This publication provides you with the following level of protection:**

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the way explained below. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

## What this Ruling is about

1. This draft Ruling is concerned with the capital gains tax (CGT) consequences under Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997* (ITAA 1997)<sup>1</sup> of standard and reverse earnout arrangements.

### Standard earnout arrangement

2. A standard earnout arrangement is any transaction in which an income-earning asset (often a business asset) is sold for consideration that includes the creation of an 'earnout right' in the seller of the asset.

3. An earnout right is a right to an amount calculated by reference to the earnings generated by the asset for a defined period following the sale (generally a period of between one and five years). It is to be distinguished from a right to a sum in respect of that sale which is certain as to amount and as to receipt, as this is '...money you...are entitled to receive...' in terms of paragraph 116-20(1)(a).

<sup>1</sup> All legislative references in this draft Ruling are to the ITAA 1997 unless otherwise stated.

## Reverse earnout arrangement

4. A reverse earnout arrangement is a contract for the sale of an asset in which the seller of an asset accepts a nominated sum by way of consideration, but undertakes to pay an amount or amounts (post-sale payments) to the buyer calculated by reference to the earnings generated by the asset during a specified period after completion of the sale.

5. In a reverse earnout, the earnout right is the *buyer's* right to a post-sale payment whereas, in a standard earnout, the earnout right is the *seller's* right to the possibility of a post-sale payment.

6. The draft Ruling explains:

- the capital gains tax consequences for the buyer and seller when the CGT event happens to the original asset; and
- the capital gains tax consequences for the buyer and the seller when the seller's entitlement in a standard earnout arrangement (or buyer's entitlement in the case of a reverse earnout arrangement) is satisfied or otherwise comes to an end.

## Explanation of terms

7. In the draft Ruling:

- the reference to 'asset' includes, unless the contrary suggests otherwise, a reference to 'assets';
- the asset given by the seller under the earnout arrangement is referred to as the 'original asset'; and
- unless otherwise indicated, statements relating to cost base should also be taken to apply to reduced cost base.

## Illustration

8. The following is a simplified example of a typical standard earnout arrangement:

- a seller wishes to dispose of all of the shares in a company which owns and operates a business;
- the seller considers that the market value of the shares is \$600,000. This valuation is based on projections that the business will generate sales of \$450,000 per annum;

- a potential buyer considers that the shares are worth an amount somewhere in the range of \$400,000 to \$600,000. The seller agrees to sell the shares to the buyer on terms that will take into account the performance of the business in the succeeding two years;
- the parties enter into a contract in which the buyer agrees to pay the following consideration for the shares:
  - a lump sum of \$400,000; and
  - 50% of the amount by which its gross annual turnover exceeds \$250,000 in each of the next two years,
- consistent with the seller's projections, in each of the next two years the gross annual sales of the business is \$450,000. Accordingly, the buyer is required to pay a further amount of \$100,000 at the conclusion of each of those years.

9. The following is a simplified example of a typical reverse earnout arrangement:

- a seller wishes to dispose of all of the shares in a company which owns and operates a business;
- the seller considers that the market value of the shares is \$600,000. This valuation is based on projections that the business will generate sales of \$450,000 per annum;
- a potential buyer considers that the shares are worth an amount somewhere in the range of \$400,000 to \$600,000. The buyer agrees to pay \$600,000, but wants an undertaking from the seller to pay him or her subsequent amounts on terms that will take into account the performance of the business in the succeeding two years;
- the parties enter into a contract in which:
  - the buyer agrees to pay \$600,000 consideration for the shares; and
  - the seller agrees to pay the buyer 50% of the amount (if any) by which the business turnover falls below \$450,000 in each of the two years following the sale, and
- in the next two years, the gross annual business sales of the business are \$425,000 and \$435,000 respectively. Accordingly, the seller is required to pay to the buyer \$12,500 at the conclusion of the first year and \$7,500 at the conclusion of the second year.

## Ordinary income

10. The draft Ruling does not deal with the possibility that an earnout receipt may be assessable, in full or in part, as ordinary income. It would only be in extreme circumstances where an earnout of between one to five years on the sale of a business asset might conceivably generate ordinary income (*Chadwick v. Pearl Life Insurance* [1905] 2 KB 507).

## Ruling

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### Standard earnout arrangements

11. The application of the CGT provisions to standard earnout arrangements are outlined below.

#### The seller

##### ***Capital proceeds for the sale of the original asset***

12. Under section 116-20, the earnout right is not an entitlement to money for the purposes of calculating the seller's capital proceeds from CGT event A1. An earnout right is 'other property ... received' by the seller in respect of the disposal of the original asset.

13. Accordingly, the seller's capital proceeds from that event includes the market value of that right (worked out at the time of the CGT event).

14. It is not possible for the seller to 'look-through' the earnout right and to treat any payments made in relation to it as the capital proceeds in respect of the disposal of the original asset.

##### ***Earnout right – nature and time of acquisition***

15. The earnout right is property, and a CGT asset, in the hands of the seller. It commences to be owned and is acquired for the purposes of section 109-5 at the time the contract for the sale of the original asset is made.

##### ***First element of the cost base of the earnout right***

16. Under subsection 112-30(1), the first element of cost base of the earnout right is that part (which may be all) of the market value of the original asset given by the seller in exchange for the earnout right as is reasonably attributable to its acquisition.

***Ending of the earnout right (CGT event C2) and other CGT events***

17. Generally, the seller's ownership of an earnout right will come to an end when satisfied by the payment of an amount or amounts by the buyer, or by expiring without any amounts becoming payable. In each of these situations, CGT event C2 (about cancellation, surrender and similar endings) happens.<sup>2</sup>

18. The contract for the sale of the original asset for an earnout right is not a 'contract that results in the asset ending' under paragraph 104-25(2)(a). Accordingly, under paragraph 104-25(2)(b), the time of the CGT event is when the right ends and not before.

19. Where an earnout is discharged progressively in instalments, the CGT treatment will differ depending on the circumstances of the payments. In some circumstances, it will be appropriate to regard each right to an instalment as a separate CGT asset. In others, it may be more appropriately characterised as part of a single CGT asset comprising the totality of rights under a contract covering both the sale of the original asset and of the earnout arrangement.

20. The totality of rights under a contract is generally regarded as a single asset for CGT purposes. However, this is ultimately a question of fact to be determined on a case by case basis.

21. Where the rights to progressive payments are part of a single CGT asset comprising the totality of the rights under a single contract, CGT event C2 happens to part of it at the time specified for each payment (other than the final payment). The seller's cost base for the part of the right to which the event happens is apportioned according to the formula in subsection 112-30(3). Under subsection 112-30(4), the remainder of the cost base after each payment date is attributed to the part of the asset that remains.

22. Where each right to a progressive payment under the earnout arrangement is a separate CGT asset, the seller is required to determine the cost base of each separate right when it is acquired. Under subsection 112-30(1), the first element of the cost base of each right is that part of the expenditure that relates to its acquisition.

***Availability of small business concessions***

23. An earnout right is not an 'active asset'<sup>3</sup> and is ineligible for concessional treatment under the small business CGT provisions in Division 152.

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<sup>2</sup> A number of other CGT events may happen in relation to the earnout right before it ends. For example, CGT event A1 happens if the seller assigns the right to another entity.

<sup>3</sup> As defined in section 152-40. See paragraphs 123 to 124 of this draft Ruling.

## **The buyer**

### ***First element of cost base of the original asset***

24. The creation of an earnout right in the seller under a contract of sale is the giving of property by the buyer for the purposes of the cost base rules in the CGT provisions. Accordingly, under subsection 110-25(2), when a buyer acquires a CGT asset in exchange for the granting of an earnout right, the first element of the buyer's cost base of the asset includes the market value of the right (worked out at the time of acquisition).

25. A buyer who has created an earnout right is not required to pay 'money' for the purposes of the cost base rules. Further, any money later paid pursuant to the earnout arrangement is not paid to acquire the original asset, but is paid to discharge the buyer's obligation under the earnout arrangement.<sup>4</sup>

### ***CGT event D1 does not happen***

26. Under paragraph 104-35(5)(a), in creating the earnout right the buyer is considered to be 'borrowing money or obtaining credit' from the seller. Accordingly, CGT event D1 does not happen as a result of the creation of an earnout right in the seller.

## **Reverse earnout arrangements**

27. The application of the CGT provisions to reverse earnout arrangements is outlined below.

## **The seller**

28. The creation by the seller in the buyer of a right to a post-sale payment or payments (reverse earnout right) is considered to have been granted 'by way of borrowing money or obtaining credit' under paragraph 104-35(5)(a). Accordingly, CGT event D1 does not happen in these circumstances, although a reverse earnout right is nevertheless created by the seller in the buyer.

29. It follows that the initial payment received by the seller under a reverse earnout arrangement is received in connection with a transaction that relates to a CGT event (the disposal of the original asset) and 'something else' (the creation of the reverse earnout right in the buyer). Under subsection 116-40(2), the seller's capital proceeds from the CGT event exclude so much of the payment as is reasonably attributable to the granting of the right.

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<sup>4</sup> In the context of consolidated groups, such a payment is not therefore considered to be 'money paid, or required to be paid, in respect of acquiring a membership interest' for the purposes of subparagraph 705-65(5B)(a)(i). Rather, the creation of the earnout right is property given in respect of that acquisition.

**The buyer**

30. Under a reverse earnout arrangement, the buyer acquires a CGT asset in the form of the reverse earnout right. The buyer's cost base for this CGT asset is so much of the original purchase price that is reasonably attributable to the acquisition of the right (subsection 112-30(1)).

31. When an amount becomes payable in respect of the right or part of the right (or when the right or part of the right expires with no amount being payable), CGT event C2 happens to the right or relevant part. The buyer's capital proceeds from the CGT event will generally be the amount payable by the seller under the reverse earnout arrangement.

32. It is not possible for the buyer to 'look-through' the reverse earnout right so as to treat the amounts paid to satisfy the right as being relevant solely to the calculation of the first element of the cost base of the original asset.

**Application of the 'Repaid Rule' and recoupment provision to reverse earnout arrangements**

33. A payment made by the seller to the buyer pursuant to a reverse earnout arrangement is not a refund of part of the purchase price. It is properly characterised as an amount paid to discharge an independent obligation created by the seller's promise to pay an amount to the buyer calculated by reference to the earnings of the asset.

34. Accordingly, a payment made by a seller pursuant to a reverse earnout arrangement:

- (a) does not attract the operation of the 'repaid rule' in section 116-50 and therefore does not bring about a reduction in the seller's capital proceeds from the original sale;
- (b) does not give rise to a capital loss for the seller (no CGT event happens to any CGT asset of the seller); and
- (c) is not a 'recoupment' of the buyer's expenditure under subsection 110-45(3).

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**Examples****Example 1**

35. Web Pty Ltd (Web) operates an internet development company which caters to a niche market. John owns all of Web's shares and manages its business operations.



36. CQ Ltd is a listed public company which operates a number of diverse information technology businesses. Its directors wish to expand its operations to include web development. They enter into negotiations with John to acquire all his shares in Web.

37. On 30 September 2008, John agrees to sell his Web shares to CQ Ltd for the following consideration:

- a lump sum cash payment of \$5 million; and
- an 'earnout' right entitling him to further cash payments of 50% of the excess (if any) of Web's turnover over \$1,500,000 at the conclusion of the current tax year and the succeeding two tax years.

38. At the time of the sale contract, the earnout right has a market value of \$400,000.

39. The right to the first payment under the earnout has a market value of \$150,000, the right to the second payment has a market value of \$130,000 and the right to the third payment has a market value of \$120,000.

40. Web was incorporated in December of 1999.<sup>5</sup> Accordingly, John is not entitled to use the frozen indexation method to calculate his capital gain. The total cost bases for the shares in his shareholding is \$2 million.

## **CGT consequences of the share sale**

### ***John***

41. CGT event A1 happens as a result of the sale of the Web shares. John's capital proceeds from this event include the amount of the lump sum cash payment and the market value of the earnout right (worked out at the time of the event).

42. At the time of the sale contract, John acquires a CGT asset (an earnout right) in the form of a chose in action comprising his rights under the earnout arrangement.

### ***CQ Ltd***

43. The first element of CQ's cost bases for the Web shares is based on the total of the amount of the lump sum cash payment and the market value of the earnout right (worked out at the time of the acquisition).

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<sup>5</sup> See below at paragraphs 125 to 128.

**Example 2**

44. Assume the same facts as Example 1. Web's turnover is \$2,000,000 in the year ending 30 June 2009, \$1,500,000 in the year ending 30 June 2010 and \$1,750,000 in the year ending 30 June 2011.

45. In accordance with the sale agreement, John is entitled to \$250,000 in the first year, no payment in the second year and \$125,000 in the third year.

46. Just after the conclusion of the year ending 30 June 2009, the remainder of the right has a market value of \$270,000.

**CGT consequences of the earnout arrangement*****John***

*Earnout right is, on the facts, a single CGT asset*

47. At the conclusion of each of the years ending 30 June 2009 and 30 June 2010, CGT event C2 happens to part of the right. John's capital gain or loss from those events is worked out as follows.

***Year ending 30 June 2009***

48. On 30 June 2009, CGT event C2 happens to a proportionate part of the earnout right. The capital proceeds from this event are the amount which John is entitled to receive (and CQ is obliged to pay) in that year (\$250,000).

49. Under subsection 112-30(3), the cost base of the CGT asset representing the part to which the CGT event happened is calculated as follows:

$$\begin{array}{rcl}
 \begin{array}{l} \text{Cost} \\ \text{base/reduced} \\ \text{cost base of} \\ \text{the right} \end{array} & \times & \begin{array}{l} \text{Capital proceeds from the} \\ \text{CGT event happening to the part} \\ \text{Those capital proceeds plus the market value} \\ \text{of the remainder of the asset.} \end{array} \\
 = \$400,000 \times [\$250,000 / (\$250,000 + \$270,000)] & & \\
 = \$192,308 & & 
 \end{array}$$

50. Under subsection 112-30(4), this amount is deducted from the original cost base of the asset to form the cost base of the remaining part of the asset resulting in a cost base for that part equal to \$207,692 (\$400,000 - \$192,308).

51. Assuming no other relevant expenditure, John makes a capital gain of \$57,692 (capital proceeds of \$250,000 less cost base of \$192,308).

## *Year ending 30 June 2010*

52. On 30 June 2010, CGT event C2 happens to a part of the remainder of the earnout right. John has no capital proceeds from this event as CQ is not obliged to pay anything at this time.

53. Where there are no capital proceeds from a CGT event that happens to part of a CGT asset, the cost base of the part that ends is also nil. Accordingly, John will not have a capital gain or loss in this year. There is no practical requirement for John to calculate the market value of the remainder of the asset.

## *Year ending 30 June 2011*

54. At the year ending 30 June 2011, the earnout right comes to a complete end. In this case, CGT event C2 happens to the whole, not to part, of the relevant CGT asset. Accordingly, the cost base from this CGT event is not subject to apportionment.

55. Assuming he has made no other relevant expenditure, John makes a capital loss of \$82,692 (reduced cost base of \$207,692 less capital proceeds of \$125,000).

### ***Each right to a payment under the earnout right is, on the facts, a separate CGT asset***

56. In this case, John is considered to have incurred expenditure by giving property and, in exchange, to have received a combination of money and property in the form of three separate earnout rights. The first element of the cost base of each right is that part of the expenditure that relates to its acquisition (subsection 112-30(1)).

57. The first element of the cost base of:

- the right to the first payment is \$150,000;
- the right to the second payment is \$130,000; and
- the right to the third payment is \$120,000.

58. Assuming no other relevant expenditure, John would make:

- a capital gain of \$100,000 in the first year;
- a capital loss of \$130,000 in the second year; and
- a capital gain of \$5,000 in the third year.

## **Example 3**

### **Reverse earnout**

59. George carries on business in a small way as a sole trader.

60. George agrees to sell his business to X Pty Ltd for a lump sum payment of \$1,000,000 payable on the date of settlement.

61. Under the contract, George also agrees to pay to X Pty Ltd 30% of the amount (if any) by which the business turnover falls below \$250,000 for each of the three years following the sale (up to a maximum of \$50,000 in each year).

62. The CGT consequences of the transaction are as follows.

### **George**

63. Under the sale agreement, George has total capital proceeds of \$1,000,000 in respect of:

- the disposal of the business assets (CGT event A1); and
- the creation in X Pty Ltd of a reverse earnout right.

64. Under subsection 116-40(2), George's capital proceeds from the disposal of the business assets is so much of the total sale price as is reasonably attributable to the disposal.

65. No CGT event happens as a result of the grant by George to X Pty Ltd of the reverse earnout right. That part of the sale price that is reasonably attributable to the creation of this right is not taken into account in working out a capital gain or loss on the sale of the business assets in George's hands.

### **X Pty Ltd**

66. Under the sale agreement, X Pty Ltd acquires, for CGT purposes:

- the business assets; and
- a CGT asset in the form of the reverse earnout right.

67. Under subsection 112-30(1), the first element of X Pty Ltd's cost base for each asset it acquires – including the reverse earnout right – is so much of the total purchase price as is reasonably attributable to that asset.

### **Example 4**

68. Assume the same facts as Example 3.

69. At the time the sale contract is entered into, \$75,000 of the total proceeds of sale is reasonably attributable to the grant of the reverse earnout right. Similarly, \$75,000 of its total purchase price is reasonably attributable to the acquisition of that right.

70. The post-sale business turnover is:

- \$200,000 in the first year requiring a repayment of \$15,000 by George to X Pty Ltd;

- \$300,000 in the second year so that no repayment is required; and
- \$100,000 in the third year so that \$45,000 is payable by George.

71. The value of the reverse earnout right is:

- \$45,000 after the first repayment; and
- \$20,000 at the conclusion of the second year after the sale.

## **George**

72. The repayment of amounts by George in the first and third years does not give rise to a capital gain or loss in George's hands and has no effect on the calculation of his capital gain or loss from disposal of the assets of his business.

## **X Pty Ltd**

73. On each occasion on which a post-sale payment is made by George under the contract, CGT event C2 happens as result of the partial satisfaction of the CGT asset comprised by X Pty Ltd's reverse earnout right.

74. Similarly, at the conclusion of the second year, C2 happens as a result of the expiry or partial expiry of the right.

75. Applying the cost base apportionment formula in subsection 112-30(3), X Pty Ltd's capital gain or loss from the repayments is as follows:

### **Year one**

The amounts for year one are:

$$\begin{aligned}\text{Reduced cost base} &= \$75,000 \times [\$15,000 / (\$15,000 + \$45,000)] \\ &= \$18,750\end{aligned}$$

$$\text{Capital proceeds} = \$15,000$$

$$\text{Capital loss} = \$3,750$$

### **Year two**

No gain or loss is made as the cost base and reduced cost base (worked out in accordance with subsections 112-30(3) and (4)) and the capital proceeds are both nil.

### **Year three**

The amounts for year three are:

$$\text{Reduced cost base} = \$56,250$$

$$\text{Capital proceeds} = \$45,000$$

$$\text{Capital loss} = \$11,250$$

## **Date of effect**

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76. It is proposed that when the final Ruling is issued, the Ruling will apply to years of income commencing both before and after its date of issue. However, there are two exceptions.

77. The first exception is that the Ruling will not apply to a taxpayer to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

78. The second exception is if an arrangement involving a standard earnout right was begun to be carried out before 17 October 2007 (being the date Taxation Ruling TR 93/15 was withdrawn) and the outcome provided by the Ruling is less favourable to a taxpayer than that provided by the withdrawn Taxation Ruling TR 93/15. In that case, the Ruling will not apply (and Taxation Ruling TR 93/15 will). An arrangement involving an earnout right is considered to have been 'begun to be carried out' when the earnout right is acquired by the seller for CGT purposes. This is when the contract for the sale of the original asset is made.

## **Previous rulings**

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79. Taxation Ruling TR 93/15 is withdrawn on and from the issue date of this draft Ruling.

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**Commissioner of Taxation**  
17 October 2007

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## Appendix 1 – Explanation

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**①** *This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.*

### Standard earnout arrangements

#### Issues for the seller

##### ***Capital proceeds for the sale of the original asset***

80. Generally, the capital proceeds from a CGT event comprise the sum of the money you have received, or are entitled to receive, in respect of the event happening and the market value of any other property you have received, or are entitled to receive, in respect of the event happening (section 116-20).

81. The money the seller is entitled to receive in respect of the event happening (paragraph 116-20(1)(a)) is limited to the known or ascertainable amounts that are receivable in respect of the CGT event. For the avoidance of doubt, this includes any fixed amounts which the seller is entitled to receive at a later time (section 103-10).

82. An earnout right does not confer an entitlement to receive money for these purposes. Further, a feature of earnout rights is that they are capable of expiring without any amount being payable by the buyer. In other words, there always exists the possibility that the buyer will not be required to pay any amount in relation to such rights. It follows that the seller cannot be said to be entitled to receive an amount of money because of the existence of such a right.

##### ***Can the earnout right be 'looked through'?***

83. An issue is whether it is possible to 'look-through' the earnout right to the amounts (if any) subsequently paid under it as being capital proceeds in respect of the disposal of the original asset. The answer to that is 'no'.

84. The 'look-through approach' is informed in large part by the approach taken by the UK High Court of Justice in *Zim Properties Ltd v. Proctor (Inspector of Taxes)* (1984) 129 Sol Jo 68; 58 TC 371 (*Zim Properties*). In that case, the taxpayer had contracted to sell certain property. However, the buyer was able to repudiate the contract because the taxpayer could not show good title to the property. The taxpayer then sued its solicitors for negligence and was awarded an amount of compensation for that negligence. It fell to the court to determine from which asset a settlement sum was derived, the underlying real property or the taxpayer's right to compensation.

85. Warner J considered that the choice of which was the most relevant asset depended on the 'reality of the matter'. While acknowledging the availability of a 'look-through approach' in appropriate circumstances, he concluded on the facts before him that the settlement amounts paid by the solicitors were not derived from the real estate but were derived from the right to sue, which was itself an asset.

86. In Taxation Ruling TR 95/35 the Commissioner stated that one of the principles underlying the interpretation of CGT law is the 'most relevant asset approach'. This approach is described as a process of analysing all the possible assets of a taxpayer to determine the asset to which the capital proceeds received (or entitled to be received) by that taxpayer most directly relates.

87. A further application of the general principle set out in TR 95/35 is the 'continuum of events approach' adopted by the Commissioner in Taxation Ruling TR 1999/19. In effect, this approach provides that it is only possible to relate capital proceeds to a CGT event happening to an underlying asset when they are received in the course of the same 'continuum of events' as that CGT event. Taxation Ruling TR 1999/19 explains the CGT implications of this approach to certain land transactions in which the vendor retains a forfeited deposit. It states that, depending on the circumstances, where a vendor of land retains a forfeited deposit, it may properly be regarded as part of the proceeds of a later, successful sale of that land, rather than from the disposal of contractual rights (or a right to compensation) under the original, failed contract of sale.

88. In the case of earnout arrangements, the 'reality of the matter' (to use the language of *Zim Properties*) is that the parties have entered into a financial arrangement that is independent of the sale transaction from which it arises. The mere fact that the earnout arrangement has its origins in the sale of the original asset is not sufficient justification for treating the earnout arrangement as a merely subordinate part of a larger transaction.

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



90. The UK Court of Appeal's decision of *Marren (Inspector of Taxes) v. Ingles* [1980] 3 All ER 95 provides useful guidance. In that case, a sale of unlisted company shares was transacted on the basis that the buyer would pay an immediate cash lump sum and an additional amount calculated as a proportion of the list price for the shares at such time that those shares were listed on a stock exchange, should such an event occur. It was found that the character of this transaction was manifested by both the transfer of the shares in question and the financial arrangement involving speculation on whether certain events would occur after the completion of the sale. Earnout arrangements display a similar complexity of character.

### ***Nature of earnout right in the hands of the seller***

91. The earnout right is property, and a CGT asset, in the hands of the seller.

92. The seller's right under an earnout arrangement can best be described as a *chose in action* consisting of the seller's contractual right to compel the buyer to make such payments. However, this does not settle the question of whether the right is property.

93. The leading case on the meaning of 'property' for CGT purposes is the Full Federal Court in *Hepples v. Federal Commissioner of Taxation* 91 ATC 4808; (1991) 22 ATR 465 (*Hepples*). In that case, the court held that the essential characteristic of an item of property is that it can in some way be assigned, transmitted or turned to account with a third party. They exclude from this category, relevantly, such items as:

- rights which by virtue of statute cannot be assigned (for example, the right to compensation under the trade practices legislation for false or misleading conduct);
- the benefit of a contractual obligation where the identity of the person performing the contract is crucial to the contract (as in a contract for personal services);
- future property; and
- contingent interests which have not yet vested (for example, the right of a discretionary object to a distribution of income that is contingent on the exercise of a power of appointment by a trustee).

94. Following the *Hepples* decision, in *Federal Commissioner of Taxation v. Orica Limited (formerly ICI Australia Limited)* (1998) 194 CLR 500; 39 ATR 66; 98 ATC 4494, five members<sup>6</sup> of the High Court endorsed the view of Kitto J in *National Executors & Agency Co of Australasia v. Federal Commissioner of Taxation* (1954) 91 CLR 540, at 583 that assignability is a sufficient, but not a necessary, attribute of property. Kitto J stated in that case that:

It may be said categorically that alienability is not an indispensable attribute of a right of property according to the general sense which the word 'property' bears in the law. Rights may be incapable of assignment, either because assignment is considered incompatible with their nature, as was the case originally with debts (subject to an exception in favour of the King) or because a statute so provides or considerations of public policy so require, as is the case with some salaries and pensions; yet they are all within the conception of 'property' as the word is normally understood ...

95. A right to the payment of money under an existing contract, the repudiation of which means an action can be brought for anticipatory breach, is a present chose in action: *Norman v. Federal Commissioner of Taxation (Norman)* (1963) 109 CLR 9 at 26; [1964] ALR 131 at 146. A present chose in action is capable of immediate assignment and is property according to the test in *Hepples*. A right is capable of being a present chose in action even if the extent of the right is dependent on a future contingency.

96. By contrast, a 'future chose in action' or expectancy is the mere prospect or possibility of possessing a future proprietary right: *Norman* (1963) 109 CLR 9 at 26; [1964] ALR 131 at 146; see also Starke, JG, *Assignments of Choses in Action in Australia* (1972) at page 6. An example of a future chose in action is a mere possibility that a debt will mature in one's favour. A future chose in action is not assignable at law or in equity. A purported assignment of future property may, in appropriate circumstances, be construed as a binding agreement to assign which effects an automatic transfer in equity of the subject property when it comes into existence: *Booth v. Federal Commissioner of Taxation* 87 ATC 5100; 19 ATR 514 [see also Starke above, at pages 6-7].

97. It is considered that rights acquired by the seller under an earnout arrangement are closely analogous to those acquired by the appellant in *Shepherd v. Federal Commissioner of Taxation* (1965) 113 CLR 385. In that case, Mr Shepherd purported to assign, by way of deed, his 'right, title and interest in' a proportion of royalty income that 'may accrue' under an agreement in which he had licensed the right to manufacture castors to a third party. At issue was whether the subject rights were in fact assignable.

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<sup>6</sup> Per Gaudron, McHugh, Kirby and Hayne JJ at (1998) 194 CLR 500, 537; 39 ATR 66, 92; 98 ATC 4494, 4515. Per Gummow J at (1998) 194 CLR 500, 542-3; 39 ATR 66, 96; 98 ATC 4494, 4518.

98. The High Court held that Mr Shepherd had a vested, and therefore assignable, contractual right under the licence agreement. Importantly, there existed the possibility that the licence may have generated no royalty income (for example, if the licensee had not exercised his rights under the licence agreement). The court held, however, Mr Shepherd's contractual right existed independently of the royalty income itself. Barwick CJ at 392 said that the fact that Mr Shepherd assigned his 'right' to royalties – rather than the royalties themselves – indicated that:

the taxpayer was not intending to promise that he would pay money measured by the amount of royalties accrued or that he was intending to assign the royalties themselves. Its use rather suggests, to my mind, that he was intending to place the persons he wished to benefit in the position of being able themselves to assert a right to receive the appropriate amounts from the licensee.

99. Barwick CJ emphasised that the fact that no amount may ultimately be payable for royalties does not lead to the conclusion that Mr Shepherd's 'right' to those royalties was not assignable. He stressed that the fact that promise may or may not be fruitful makes it no less capable of assignment.

100. Similarly, the seller who receives an earnout right has a vested, contractual right against the buyer, even though it may not be 'fruitful'. This right exists independently of the amounts payable under the earnout arrangement and is assignable. Accordingly, an earnout right can correctly be described as property for CGT purposes.

### ***Time of acquisition of earnout right***

101. The earnout right is acquired, for the purposes of section 109-5, at the time the contract for the sale of the original asset is made. The seller becomes the owner of an enforceable right against the buyer at this time.

### ***First element of the cost base of the earnout right in the hands of the seller***

102. The first element of cost base of an earnout right includes the market value of property given, or required to be given, in respect of its acquisition. The market value of property given is worked out as at the time of acquisition of the earnout right (paragraph 110-25(2)(b)). In a transaction of this type, the seller disposes of a CGT asset in consideration for valuable property rights (if the earnout right is the only consideration) or for a combination of money and valuable property rights (if the consideration is a fixed sum plus an earnout right).

103. If a CGT asset is sold for a combination of money and an earnout right, the first element of the seller's cost base for the right is that part of the market value of the CGT asset (being property) sold that is reasonably attributable to the acquisition of the right (subsection 112-30(1)).

104. The amount that is reasonably attributable to the acquisition of the earnout right is determined as:

- the market value (on acquisition) of the earnout right;
- the market value of the earnout right plus any money received or receivable on the disposal of the original asset; and
- the market value of the original asset at the time the contract to sell it was made.

Recognising that this amount may be difficult to determine in some circumstances, the Commissioner will generally accept an approach in which:

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

105. This approach recognises that, in the context of arm's length transactions overall, parties will tend to exchange items of similar market value.

### ***Consequences for the seller of a CGT event happening to the right***

106. There are a number of CGT events that may happen to the earnout right in the seller's hands. For example, the seller might assign the right to another entity (CGT event A1) or declare him or herself to be trustee of the right for another entity (CGT event E1).

107. When a CGT event happens in relation to the right, one of the following consequences will follow:

- if the capital proceeds from the event exceed the cost base for the right, the difference is the seller's capital gain;
- if the reduced cost base exceeds the capital proceeds, the difference will be the seller's capital loss; and
- if the capital proceeds are less than the cost base but more than the reduced cost base, the seller will have neither a capital gain nor a capital loss.

108. More commonly, the CGT event that happens to the earnout right in the hands of the seller will happen by reason of the right 'ending'. This will generally happen in one of two ways:

- by being discharged or satisfied by the payment of an amount or amounts by the buyer; and
- by expiring without any obligation arising on the part of the buyer to pay any additional amount.

109. In each of these situations, CGT event C2 (about cancellation and surrender and similar endings) happens. In the former case, the right is considered to have ended by being 'discharged' or 'satisfied' (paragraph 104-25(1)(b)). In the latter case, the right is considered to have ended by 'expiring' (paragraph 104-25(1)(c)).

110. The discharge of a chose in action by performance of the contract was held by the Full Federal Court not to be a disposal 'under a contract' for the purposes of subsection 160U(3) of the *Income Tax Assessment Act 1936* (ITAA 1936): *Federal Commissioner of Taxation v. Dulux Holdings Pty Ltd & Orica Ltd.*<sup>7</sup> Similarly, a contract for the sale of the asset for a right to an unascertainable amount is not a 'contract that results in the asset ending' for the purposes of paragraph 104-25(2)(a) of the ITAA 1997. Accordingly, under paragraph 104-25(2)(b) of the ITAA 1997, where the earnout right ends as a result of the performance by the parties of their obligations under the earnout arrangement, the time of the CGT event is when the right ends and not when the contract for the sale of the original asset was made.

111. The parties to an earnout arrangement may opt to bring a right to an end prior to its maturity date. For example, the seller may agree to release the buyer from any further obligation in respect of the right in consideration for the payment of a lump sum. In this situation the seller's ownership of the right ends by the asset being 'released, discharged or satisfied' causing CGT event C2 to happen (paragraph 104-25(1)(b)). The time of the event is when the parties entered into the agreement to bring the right to a premature end (subsection 104-25(2)).

### ***Progressive receipts of earnout amounts***

112. Amounts payable pursuant to earnout rights may be payable in a single lump sum or by a number of progressive payments. A typical example of the latter case is a contract for the sale of business that requires the buyer to make annual payments for three years of an amount calculated by reference to the gross business turnover for the preceding twelve-month period.

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<sup>7</sup> 48 ATR 588; 2001 ATC 4658; (2001) 113 FCR 436; [2001] FCA 1344.

113. The method for determining the CGT consequences of an earnout right being progressively discharged differs depending on whether the totality of rights under the earnout arrangement is a single CGT asset, or each right is a separate CGT asset.

114. The totality of rights under a contract is generally a single CGT asset for the purposes of Parts 3-1 and 3-3. However this is ultimately a question of fact to be decided on a case by case basis: Taxation Determination TD 93/86.

115. If the legal form of the agreement provides for separate payment rights (for example, in relation to particular years), and the seller wants to treat the rights as separate CGT assets, the Commissioner will not generally seek to disturb such treatment. The Commissioner recognises that compliance cost savings may result from this approach over the 'single asset' approach which would usually require that the right be valued several times as it progressively ends.

***If rights to progressive payments under the earnout arrangement are on the facts parts of a single CGT asset***

116. Where an earnout right that entitles the seller to progressive payments is a single CGT asset, CGT event C2 happens to a part of the right at the time specified for each payment (paragraph 108-5(2)(a) and subsections 112-30(2) and (3)); see also the judgment of Brennan CJ in *Federal Commissioner of Taxation v. Orica Ltd* (1998) 194 CLR 500; 39 ATR 66; 98 ATC 4494). Accordingly, the seller may realise a capital gain or loss at each such time.

117. The seller's cost base for the part of the right to which the CGT event happens is worked out using the formula in subsection 112-30(3):

$$\begin{array}{ccc} \text{Cost base of the} & \times & \begin{array}{l} \text{Capital proceeds from the} \\ \text{CGT event happening to the part} \\ \text{Those capital proceeds plus the market} \\ \text{value of the remainder of the asset.} \end{array} \\ \text{right} & & \end{array}$$

118. The amount calculated using this formula is deducted from the cost base of the asset to form the cost base of the remaining part of the asset (subsection 112-30(4)). This process is repeated each time a subsequent CGT event happens in relation to part of the asset.

119. It should be noted that if a CGT event happens to part of an asset and the capital proceeds are nil, under the formula in subsection 112-30(3), the cost base for the relevant part will also be nil. There is no practical requirement in these circumstances for the seller to determine the market value of the remainder of the earnout right.

***If each right to a progressive payment under an earnout right is on the facts a separate CGT asset***

120. Where each right to a progressive payment is a separate CGT asset, the discharge or expiry of that right is not treated as a CGT event that happens to part of a CGT asset. The applicable event happens to the whole of the relevant asset at the time of each payment. The apportionment formula in subsection 112-30(3) has no application.

121. In these circumstances, the seller is required to determine the cost base of each separate right as at the time of its acquisition. In a transaction of this type, the seller typically gives valuable property in consideration for a combination of money and two or more separate rights. The first element of the cost base of each right is that part of the expenditure that relates to its acquisition (subsection 112-30(1)). Here, the relevant expenditure is the giving of property by the seller.

122. As a result of the application of the apportionment formula in subsection 112-30(1), the first element of the cost base of each right to a progressive payment will generally be its market value at the time of its acquisition by the seller.

***Availability of small business relief for capital gains made in respect of earnout rights***

123. Where the original assets provided by the seller under an earnout arrangement satisfy the conditions in Division 152 (about small business relief), capital gains made by the seller may be reduced by one or more of the concessions contained in that Division. Relief under this Division is only available for gains made in respect of 'active assets' as defined in section 152-40.

124. Unlike the original asset, an earnout right will not satisfy the definition of 'active asset' under section 152-40. This is because:

- (a) An earnout right is not used, or held ready for use, by the seller in the course of a carrying on a business by the seller or by a small business affiliate thereof (paragraph 152-40(1)(a));
- (b) an earnout right is not an intangible asset inherently connected with a business carried on by the seller or a small business affiliate thereof (paragraph 152-40(1)(b)); and
- (c) an earnout right is in the nature of a 'financial instrument' and is excluded from the definition of 'active asset' by the exception in (paragraph 152-40(4)(d)).

***CGT discount and indexation of cost base***

125. A capital gain made from a CGT event that happens after 11.45 am (by legal time in the ACT) on 21 September 1999 may be eligible for concessional treatment as a 'discount capital gain'. In the alternative, capital gains from assets acquired at or before that time may be eligible to be calculated using a cost base that has been indexed for inflation.

126. The CGT discount and indexation of cost base are, respectively, only available if certain conditions (set out in Divisions 115 and 114) are met.

127. It is a requirement of both indexation and the CGT discount that the CGT asset is acquired at least 12 months before the CGT event. In relation to this requirement:

- An earnout right is acquired when the seller becomes the owner of the right. This will occur at the time when the CGT event happens that gives rise to the capital proceeds that include the right (in other words, the time at which the disposal of the original asset takes place); and
- In determining whether at least 12 months has elapsed from that time until the time of the CGT event, the contract for the sale of the original asset is not a contract that results in the earnout right ending for the purposes of paragraph 104-25(2)(a): *Federal Commissioner of Taxation v. Dulux Holdings Pty Ltd & Orica Ltd* 48 ATR 588, 2001 ATC 4658; (2001) 113 FCR 436; [2001] FCA 1344.

128. Where an earnout right is discharged progressively, and the totality of the buyer's rights under the earnout arrangement is regarded as a single CGT asset, the CGT discount or indexation will only be available in respect of those CGT events that occur at least 12 months after the date on which the earnout right was acquired.

**Issues for the buyer*****Cost base of the acquired asset***

129. Generally, the cost base of an asset consists of five elements. Relevantly, the first of these elements is the total of money paid (or required to be paid) and the market value of any other property given (or required to be given) in respect of acquiring the asset (subsection 110-25(2)). The reduced cost base of an asset is worked out similarly (subsection 110-55(2)).



130. Money required to be paid by the buyer in respect of the acquisition (paragraph 110-25(2)(a)) is a notion that is limited to sums to which the buyer is definitively committed to pay. For the avoidance of doubt, this includes any amounts which are to be paid after the contract time (section 103-15). However, a buyer's payment obligations under an earnout arrangement do not constitute a 'requirement to pay' money for the purposes of the cost base rules (see *Dingwall v. Federal Commissioner of Taxation* 95 ATC 4345; 30 ATR 498; (1995) ALR 297). A feature of earnout rights is that, because they are in relation to an unascertainable amount, there is a possibility that the buyer will not be required to pay any amount in relation to those rights. Accordingly, the buyer cannot be said to be 'required' to pay money because of the existence of such a right.

131. In Taxation Ruling TR 93/15, the Commissioner ruled that, in order for property to be 'given' for the purposes of subsection 160ZH(4) of the ITAA 1936, the relevant property must be transferred or conveyed from one party to another. As an earnout right is not previously part of the buyer's property, it was not considered to have been 'given' by the buyer.

132. The requirement that property must first be owned by the donor in order to be 'given' for the purposes of the cost base provisions was justified by reference to the interpretation of what were seen as analogous provisions concerning:

- 'disposition' under Commonwealth gift duty legislation: *Ord Forrest Pty Ltd v. Federal Commissioner of Taxation* (1974) 130 CLR 124; 74 ATC 4034; (1974) 4 ATR 230.
- 'sale' under Queensland income tax legislation: *Commissioner of Taxes (Qld) v. Camphin* (1937) 57 CLR 127; (1937) 4 ATD 315; 91 ATC 257; and
- whether an asset was 'acquired from another person' for the purposes of paragraph 160ZH(9)(a) of the ITAA 1936 (concerning the operation of the cost base rules when no consideration, excessive or inadequate consideration is given in respect of the acquisition of an asset): *Allina Pty Ltd v. Federal Commissioner of Taxation* 91 ATC 4195; (1991) 21 ATR 1320.

133. It is considered that the word 'give', in the context of the cost base provisions, takes its ordinary meaning and is not constrained by technical interpretations attaching to the different legislative contexts referred to above.

134. The word 'give' in its ordinary sense does not necessarily require that the thing given first be the property of the donor. For example, it can be used as a synonym for 'yield' and can mean 'to grant permission or opportunity to' (*Macquarie Dictionary*, 2nd edition).

135. The broader interpretation of 'give' is also favoured because it achieves legislative consistency with the provisions relating to the disposal of the original asset by the seller and its acquisition by the buyer. For example, the seller has to include the market value of the right, valued at the time of the contract, in its capital proceeds for the sale of the original asset. The buyer has to include the same market value of the right in the cost base of the original asset it acquires from the seller.

136. Accordingly, it is concluded that the creating of an earnout right does in fact constitute property given by the buyer for the purposes of determining the buyer's cost base for the original asset.

***Consequences for the buyer's cost base of the original asset from the earnout right's coming to an end***

137. The payment by the buyer of an amount or amounts by way of discharge of an earnout right, or the expiry of an earnout right without payment, has no effect on the buyer's cost base for the original asset.

138. To qualify for inclusion in the cost base of an asset, an item of expenditure is required to have a particular connection with the asset that is the subject of the CGT event. The amount paid by the buyer to discharge the earnout is not included in the buyer's cost base for the original asset under any of the five elements.

139. Although the earnout right is given in respect of acquiring the original asset, the same is not true of amounts paid to discharge an earnout obligation. Such amounts are incurred to discharge a liability that is independent of an obligation to pay the purchase price of the original asset. It is concluded that the payments:

- are not incurred in respect of acquiring the asset for the purposes of the first element (subsection 110-25(2));
- cannot be considered to be costs of owning the asset for the purposes of the third element (subsection 110-25(4)); and
- cannot be considered to have been incurred to 'establish, preserve or defend' the taxpayer's title to, or a right over, the asset for the purposes of the fifth element (subsection 110-25(6)).

140. For the purposes of the second element, earnout payments are not 'incidental costs'. The term 'incidental costs' is the subject of a strict definition in subsection 110-35(1) which does not encompass payments of this nature.

141. For the purposes of the fourth element, earnout payments are not incurred for the purpose or expected effect of increasing or preserving the original asset's value, and nor do they relate to installing or moving the original asset (subsection 110-25(5)).

***Does CGT event D1 happen to the buyer as a result of the creation of an earnout right in the seller?***

142. Section 104-35 provides that, in general, CGT event D1 happens if you create a contractual right or other legal or equitable right in another entity. An earnout right is clearly a 'contractual right' for these purposes.

143. When CGT event D1 happens, the creator of the relevant right will realise a capital gain equal to the capital proceeds from the CGT event reduced only by the incidental costs associated with the event (subsection 104-35(3)).

144. Subsection 104-35(5) lists a number of exceptions to the general rule as to when CGT event D1 happens. Relevantly, paragraph 104-35(5)(a) provides that CGT event D1 does not happen where the relevant right is created by 'borrowing money or obtaining credit from another entity'.

145. The verb 'to borrow' is typically equated with the taking or obtaining of a thing on promise to return it or its equivalent or with the obtaining of the temporary use of something (see the definition of 'borrow' in the *Macquarie Dictionary, 2nd edition*). The definition of 'borrowing' in subsection 995-1(1), while it is not the operative definition for the purposes of section 104-35, is also instructive. There 'borrowing' is defined to mean 'any form of borrowing, whether secured or unsecured' including 'the raising of funds by the issue of a bond, debenture, discounted security or other document evidencing indebtedness'.

146. The phrase 'obtaining credit' is not defined in either the ITAA 1997 or the ITAA 1936 and takes its ordinary meaning. The *CCH Macquarie Macquarie Dictionary of Law* equates 'credit' with the concepts of 'trust and reliance'. It states 'where goods or services are supplied on credit, the supplier defers any demand for payment until a certain amount is owed or a certain time has elapsed'.

147. Although it might be argued in some contexts that 'borrowing money or obtaining credit' would not include the creation of an earnout right in another party, it is considered that in the context of CGT event D1 the composite phrase should be given a broad interpretation. The creator of the right comes under a reciprocal obligation to render payment if the contingency is satisfied. For CGT event D1 to happen in such a case and lead to a capital gain would clearly be an anomalous outcome. This will be the case notwithstanding that no amount may ultimately become payable because of the failure of a contingency.

## **Reverse earnout arrangements**

148. Under an agreement which involves a lump sum payable and a standard earnout right, the seller has a vested entitlement to any lump sum payable but only a contingent entitlement to any further payment. A merely contingent entitlement is not regarded as an entitlement to money for the purposes of the CGT provisions.

149. An earnout arrangement can be structured differently. It can be structured so that the seller agrees to accept a nominated sum by way of consideration, but agrees to pay to the buyer further amounts calculated by reference to earnings generated by the asset during a specified period after completion of the sale (post-sale payments). In many cases, the contract of sale would describe the buyer's right to repayment as a right to a 'refund' of part of the purchase price. For the purposes of this discussion, this type of arrangement will be referred to as a 'reverse earnout' agreement. The buyer's right will be referred to as a 'reverse earnout right'.

150. An example of a reverse earnout arrangement is a contract for the sale of an income-earning asset that is transacted on terms that, to the extent that the asset fails to generate a certain return in the period after sale, the seller agrees to repay an amount to the buyer. The parties will often take steps to ensure that the buyer has adequate security for the amount potentially repayable. For example, the seller may take receipt of the full purchase price upfront and, immediately thereafter, lend an amount back to the purchaser. Amounts that become repayable by the buyer under the loan agreement would be applied or 'offset' against the outstanding loan balance owing to the seller.

151. An agreement for a reverse earnout may describe the buyer's entitlement as a right to a 'refund' of part of the purchase price. However, a repayment by the buyer is an amount paid to discharge an independent obligation constituted by the seller's promise to pay an amount to the buyer calculated by reference to the earnings of the asset. In this sense, the characterisation for tax purposes of reverse earnouts mirrors the characterisation of standard earnouts.

152. It follows from the above that a payment made by a seller pursuant to a reverse earnout arrangement:

- (a) does not attract the operation of the 'repaid rule' in section 106-50 and therefore does not bring about a reduction in the seller's capital proceeds from the original sale;
- (b) does not give rise to a capital loss for the seller (no CGT event happens to any CGT asset of the seller); and
- (c) is not a 'recoupment' of the buyer's expenditure under subsection 110-45(3).

153. The capital gains tax implications of a reverse earnout arrangement are as follows.

## ***The seller***

154. Where the original asset is sold subject to a reverse earnout arrangement, the seller's capital proceeds relates to two things: the disposal of the CGT asset and the creation of the reverse earnout right.

155. The applicable rule for apportioning the seller's capital proceeds is contained in subsection 116-40(2). The effect of this provision is that the capital proceeds from the CGT event A1 that happens as a result of the disposal of the original asset is so much of the total capital proceeds from the event as is reasonably attributable to the event. Accordingly, the seller's capital proceeds from the disposal of the assets exclude so much of the contract price as is reasonably attributable to the granting of the right. The amount that is so excluded should generally equate to the market value of the right at the time it is granted.

## ***CGT event D1***

156. The grant by the seller to the buyer of a reverse earnout right *prima facie* attracts the operation of CGT event D1. That is, under subsection 104-35, the transaction involves the creation by the seller of a contractual right in another entity, the buyer.

157. However, for the reasons set out at paragraphs 142 to 147 of this draft Ruling in relation to standard earnouts, where a seller creates a reverse earnout right, that right is considered to have been created 'by way of borrowing or obtaining credit' under paragraph 104-35(5)(a). Accordingly, CGT event D1 does not happen in these circumstances.

## ***The buyer***

158. The CGT assets acquired by the buyer under the sale agreement include the contractual right to a repayment if the relevant conditions are not met. The buyer's cost base for this right is that part of the total expenditure that is reasonably attributable to the acquisition of the right (subsection 112-30(1)). This will generally equate with its market value at the time the contract is entered into.

159. When an amount becomes payable in respect of the right or part of the right (or when the right or part of the right expires with no amount being payable), CGT event C2 happens to the right or relevant part. The buyer's capital proceeds from the CGT event will generally be the amount payable under the reverse earnout arrangement.

**Application of a ‘look-through’ approach to reverse earnout rights**

160. Under a ‘look-through’ approach, it may be contended that the receipt and subsequent satisfaction of a reverse earnout right is relevant only to the determination of the buyer’s cost base for the original asset.

161. As with a standard earnout, a reverse earnout is an arrangement under which each party stands to receive a financial benefit in an amount determined by reference to activities associated with the asset in the period after the sale has been completed. In this sense, the transaction is a financial arrangement in its own right. It is not merely a subordinate part of, nor does it merely facilitate, the sale of the original asset. Accordingly, it is inappropriate to look-through a reverse earnout arrangement.

## Appendix 2 – Your comments

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162. We invite you to comment on this draft Taxation Ruling. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

<b>Due date:</b>	<b>30 November 2007</b>
<b>Contact officer:</b>	<b>Nick Seal</b>
<b>Email address:</b>	<b>Earnouts@ato.gov.au</b>
<b>Telephone:</b>	<b>(03) 9285 1592</b>
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<b>Address:</b>	<b>Australian Taxation Office 2 Lonsdale Street Melbourne VIC 3000</b>

## **Appendix 3 – Detailed contents list**

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Not previously issued as a draft

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- active asset
- capital gains
- CGT assets
- CGT capital proceeds
- CGT capital proceeds modification apportionment rule
- CGT cost base
- CGT cost base modification apportionment rule
- CGT discount
- CGT event A1 – disposal of a CGT asset
- CGT event C1-C2 – end of a CGT asset
- CGT events D1-D3 – bringing into existence a CGT asset
- CGT frozen indexed cost base
- CGT small business relief
- time of CGT event

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