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The CGT implications of earnout arrangements

The Commissioner of Taxation has issued an important draft ruling on earnout arrangements. An earnout applies typically where a business is sold and the seller is paid so much on settlement but receives an additional amount, “the earnout”, if certain profitability targets are reached. The ruling covers both this and also a reverse earnout, in which the seller undertakes to make certain payments to the buyer after completion, based on the under performance (if any) of the business.

What are the tax implications of a standard earnout?

Until now, it was generally considered that the earnout formed part of the consideration for the sale of a business under the normal disposal CGT event A1. The draft ruling, in contrast, states the earnout is in addition to the entitlement to money for the purposes of calculating the seller’s capital proceeds from the CGT event. An earnout right is ‘other property ... received’ by the seller in respect of the disposal of the original asset (for example, the goodwill of the business being sold). In other words, the consideration for the sale of the business is cash plus the earnout right. The earnout right is part of the capital proceeds for the sale of the business, and its market value must therefore be determined in order to determine the capital proceeds and thus the capital gain on the business sale.

Is the earnout right a CGT asset itself?

The Commissioner considers that an earnout right is a separate CGT asset and the first element of its cost base is its market value. The seller’s ownership of an asset will come to an end when satisfied by amounts paid by the buyer or not, depending on business performance. At such time, a CGT event will occur as the right is cancelled, surrendered or otherwise comes to an end. The CGT event happens when the earnout right ends and not before.

What if the earnout is paid in instalments or progressively?

In some cases each instalment maybe considered as the ending of a separate CGT asset. In other scenarios, there might be just one asset. Either way, if there is a series of separate payments under the earnout, a CGT event will apply as the whole or a part of the asset comes to an end when the payment is made. The draft ruling also makes the point that the small business CGT concessions do not apply to earnouts as earnouts are not active assets.

So what does this mean in practice?

We will demonstrate by way of example from the ruling itself the practical outcomes from the Commissioner’s viewpoint. X sells a business for \$5 million, with an earnout of an additional \$1.5 million. The consideration for the sale is \$5 million plus the market value of the earnout, which is valued by a business valuer

at a discount based on the risk of non-achievement at \$500,000. Accordingly, the capital proceeds total \$5.5 million, so the business owner will have to pay CGT on \$500,000 which not only has not been received but may never do so.

What is the result where performance is achieved and the full \$1.5 million is paid?

Assuming the earnout is paid, there is a further gain of \$1.5 million less \$500,000 at a later stage. This gain may be split into different income years if the payments are progressive. The owner will pay CGT on \$1 million. If the seller is an individual or a trust, the CGT discount may be claimed under this scenario, where payment is made more than 12 months after the business was sold. Furthermore, the Commissioner is of the view that the earnout amount will not form part of the cost base for the purchaser.

What is the result where performance is not achieved and the earnout is not payable?

Assuming the earnout is not payable, the seller will make a capital loss of \$500,000, which will be quarantined against future capital gains. The CGT rules do not contain any clawbacks, so the real consideration for the sale is \$5 million, and not \$5.5 million which means a higher effective rate of tax. Further, if the seller was retiring, it may be less likely that he or she would make further capital gains in the future.

What about the small business CGT concessions?

In the above scenario, it is fortunate that we are dealing with two separate assets, as the maximum net asset value threshold of \$6 million will not be breached unless the seller or connected entities have other business assets (excluding those in superannuation). If the \$1.5 million had been in the original sale price, the threshold would have been breached immediately.

However, were the sale price say \$3 million and the earnout \$750,000 the result is not as favourable. Assuming the earnout has a value of say \$250,000, \$3.25 million would be subject to the small CGT business concessions, whereas the \$500,000 above would not – only the CGT discount would be available in this scenario (assuming the seller was a trust or an individual).

What about reverse earnouts?

The creation by the seller in the buyer of a right to a post-sale payment or payments (reverse earnout right) is granted 'by way of borrowing money or obtaining credit'. 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.

The effect is that the capital proceeds for the seller will be less than the money actually received by the seller, as part of that money will relate to the creation of the reverse earnout right. Again, a valuation will likely be necessary.

The buyer on the other hand will have acquired the reverse earnout right for market value, and so the buyer's cost base in the business acquired will be reduced accordingly.

What happens if the seller has to pay money under the reverse earnout?

There are no CGT consequences for the seller, neither a gain nor a loss. It is a similar outcome to the normal earnout where the additional consideration is not paid, except that there is no capital loss for the seller. The seller is, in effect repaying consideration to the buyer, part of which may have been taxed, depending on the value of the reverse earnout.

What about the buyer?

A CGT event arises so that the buyer pays tax on the difference between the market value at the time of issue and the amount actually paid. It follows that if there is nothing paid, there will be a capital loss.

What does this mean for negotiations in relation to the sale of businesses?

Such negotiations are going to be needlessly complicated by this draft ruling. In every case, it will be necessary for taxpayers to work out the tax consequences under earnout arrangements and to consider whether a reverse earnout would deliver a better outcome. Due to the uncertainty with earnouts, this will prove difficult in practice.

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