Tel: +61 7 3237 5999
Fax: +61 7 3221 9227
www.bdo.com.au

Level 10, 12 Creek St
Brisbane QLD 4000
GPO Box 457 Brisbane QLD 4001
Australia

By email: taxlawdesign@treasury.gov.au

Mr Tom Reid
General Manager
Law Design Practice
The Treasury
Langton Crescent
PARKES ACT 2600

21 May 2015

Dear Mr Reid

EXPOSURE DRAFT LEGISLATION - TAX AND SUPERANNUATION LAWS AMENDMENT (2015 MEASURES NO. 4) BILL 2015: CGT TREATMENT OF EARNOUT RIGHTS

BDO welcomes the opportunity to provide a submission on the Exposure Draft Legislation: *Tax and Superannuation Laws Amendment (2015 Measures No. 4) Bill 2015: CGT treatment of earnout rights* (Exposure Draft), and the accompanying *Explanatory Materials* (EM) released by Treasury for public consultation on 23 April 2015.

We make the submissions set out below in respect of the matters addressed in the Exposure Draft and EM.

Unless otherwise indicated, references to statutory provisions are references to the provisions of the *Income Tax Assessment Act 1997*.

Overall

Overall we believe that the proposed measures provide meaningful improvements in addressing the shortcomings in the approach adopted by the Australian Taxation Office in TR 2007/D10. However, there are a number of areas in which the proposed measures could be further improved.

The measures are inappropriately restricted to CGT event A1 (proposed s112-36(1), s116-120(1) and s118-565(1)(c))

In limiting the proposed new measures to CGT event A1, the measures ignore other CGT events that could occur on the sale of a business, including CGT events B1, D1, E2 and K6. Consideration should be given to extending the application of the proposed provisions to these other CGT events.

We note that the '*Summary of feedback from targeted consultation*' indicates that the look through treatment will apply where other CGT events happen provided CGT event A1 also happens. CGT event A1 can also happen together with CGT events B1, D1, and K6, however, neither the Exposure Draft nor the EM discusses the operation of section 102-25, which, in many cases would override the operation of A1 for the more specific event such as B1, D1, or K6. It could be argued that section 102-25 would apply to ignore the CGT event A1 where a more specific CGT event can happen. This argument could be countered by a comment in the EM making it clear that the look through approach can apply to

where CGT event A1 and one of these other CGT events has potential operation even where s102-25 overrides CGT event A1 for the more specific CGT event.

There are other events that could happen in relation to the disposal of business assets where there is no disposal e.g. CGT event D1 on the creation of rights in another person. The creation of rights in another person is a not uncommon CGT event in the context of a business sale. The fact that it does not involve a CGT event A1 should not preclude it from being considered under the look through approach to earnouts.

The measures should extend to the treatment of depreciable assets under Division 40

The same issues that arise for CGT assets addressed under the CGT provisions can arise for CGT assets which are addressed in Division 40. As acknowledged in Treasury's '*Summary of feedback from targeted consultation*' (released by Treasury at the same time as the Exposure Draft and EM), mining tenements and intellectual property can fall on either side of the Division 40/non-Division 40 divide. A similar impetus for the alignment of tax treatment motivated the repeal of Subdivisions 124-G and 124-H and their replacement by Division 615. In a similar vein, we submit that 'look through' treatment of earnout rights should extend to assets which fall to be dealt with under Division 40.

The four year time period allowed appears to be unduly short (s118-565(1)(e))

We submit that the currently proposed four year maximum time period for a "look-through earnout right" is unduly restrictive. The five year period suggested in the May 2010 *Discussion Paper - Capital Gains Tax Treatment of Earnout Arrangements* released by Treasury seems to strike a better balance between flexibility and certainty.

The restriction of the relevant contingency to the economic performance of the CGT asset or business in which the CGT asset is used seems unduly narrow (s118-565(1)(f))

The restriction of the measure of the contingency to the economic performance of the assets will leave a large number of sales of CGT assets to be dealt with under TR 2007/D10. An example of this limitation is provided in paragraph 1.40 of the EM where it states:

> *"For example, a right to future financial benefits in relation to a potential mineral resource based on the value of any ore reserves once identified is not contingent on economic performance - rather it is contingent on* [sic] *purely on obtaining further information about an existing asset."*

We consider the requirement that the earnout be contingent on economic performance of the asset or business is too restrictive and we suggest it should be widened to include other contingences that affect the value of the asset or business where those contingencies are relevant to the asset's use or business' operation.

Certainty in respect of the six million dollar threshold for the small business CGT concessions

It would be desirable for the EM to confirm that the amount of capital proceeds determined under the provisions of the Exposure Draft does not affect the calculation of the value of the relevant assets for the purposes of the six million dollar threshold under Division 152.

It is not clear in either the Exposure Draft or EM that the $6 million net asset value test is based on the market value of the relevant assets at the time of the original CGT event. That is, the market value of the earnout which will have been included initially in the market value of the relevant asset will not be

replaced by the amounts subsequently received under the earnout. This would be consistent with the Assistant Treasurer's Press Release of 12 May 2010 which states that:

> *"In particular, the changes will benefit small business taxpayers by ensuring any small business capital gains tax concessions that were available on the sale of the business (or business assets) are also available for capital gains made on subsequent earnout payments."*

Also in the Treasury Proposals Paper of May 2010 in paragraph 3.1.1 it is stated that:

> *"Any capital gain is treated as realised on the business asset and is eligible for any CGT concessions that were available for that asset."*

We note that the following statements in the EM could be misunderstood to mean the payments that are received under the earnout could retrospectively affect the $6million asset threshold:

> *"1.84 The changes to the treatment of look-through earnout rights are only intended to affect a taxpayer's entitlement to CGT concessions insofar as this may occur as a result of the value of the underlying disposal now including all of the amounts provided for and under the earnout right.*
>
> *1.85 In general, this is achieved without the need for additional special rules. Taxpayers are entitled to remake choices relating to the disposal or the asset they received as a result of the disposal. As a result, taxpayers may reconsider any choices and their entitlement to concessions in light of subsequent payments ensure that the resulting gain, loss or cost base reflects any concessions that are available and only those concessions that are available."*

We suggest that these comments be re-worded to make it clear that the earnout payments will not affect the calculation of the $6million assets test

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Should you have any questions, or wish to discuss any of the comments made in the above submissions, please do not hesitate to contact Lance Cunningham on 02 9240 9736 or lance.cunningham@bdo.com.au or Matthew Wallace on 02 9240 9760 or matthew.wallace@bdo.com.au.

Yours sincerely

Lance Cunningham

BDO National Tax Director

Matthew Wallace

BDO National Tax Counsel