Capital gains tax treatment of earnout arrangements
CONSULTATION PROCESS

Request for feedback and comments

We invite interested parties to lodge written submissions on the design of this proposal, including interaction issues with other parts of the tax law, which may be relevant to its design. While submissions may be lodged electronically, by post or by facsimile, electronic lodgement is preferred.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the Freedom of Information Act 1982 for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

Closing date for submissions: Friday, 11 June 2010

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FOREWORD

I am pleased to release this discussion paper on a proposal to address the capital gains tax treatment of earnout arrangements. Earnout arrangements are a common and efficient way of structuring the sale of a business (or business assets) to deal with uncertainty about its value. These changes will make it easier to buy and sell businesses in these circumstances. This paper provides an opportunity for interested parties to express their opinions on the implementation of the proposal.

Consultation plays a valuable role in the development of policy responses to changes in the tax law and I look forward to receiving the views of the community on these important reforms.

SIGNED

Assistant Treasurer

Senator Nick Sherry
SUMMARY

On 12 May 2010, the Assistant Treasurer, the Hon Nick Sherry MP, announced that the Government will provide ‘look-through’ treatment for qualifying earnout arrangements. A copy of the press release is available on the Assistant Treasurer’s website.

Earnout arrangements are a common and efficient way of structuring the sale of an asset to deal with uncertainty about the value of the asset, for example the goodwill attached to a business. The proceeds for the sale of the business (or assets of the business) typically include a lump sum payment plus a right to further payments that are contingent on the performance of the business — an ‘earnout right’.

The proposed measure will treat additional payments made under a ‘standard’ earnout arrangement as capital proceeds for the original asset for the seller and add to the asset’s cost base for the buyer. It will treat payments made under a ‘reverse’ earnout arrangement as effectively a repayment of part of the capital proceeds for the disposal of the business asset.
1. **PURPOSE**

This discussion paper forms the basis for consultation on the design of this proposal and sets out the way it may be implemented. The purpose of this discussion paper is to provide interested parties with an opportunity to comment on the proposal’s design.

2. **BACKGROUND**

2.1 **OPERATION OF EXISTING LAW**

The Australian Taxation Office (ATO) released Draft Taxation Ruling TR 2007/D10 regarding the treatment of earnout arrangements on 17 October 2007. This draft Ruling treats an earnout right created under an arrangement to sell a business as an asset that is separate to the business for capital gains tax (CGT) purposes.

- In a standard earnout arrangement, the proceeds from the sale of the asset include the lump sum amount (whether cash or property), plus the estimated market value of the earnout right. The seller holds the earnout right.

- In a reverse earnout arrangement, part of the lump sum amount received from the buyer is proceeds for the sale of the asset, and part is proceeds for the creation of the reverse earnout right. The buyer holds the reverse earnout right.

Subsequent payments relate to the earnout right and may trigger CGT consequences for its holder, depending on the amount received and the cost base of the right (broadly reflecting its estimated market value).

Example 1 sets out the current tax treatment of the seller and buyer of a business using a standard earnout arrangement.

**Example 1. Operation of the current law**

Two parties agree that a business is worth at least $800,000, but potentially $1 million or more if the majority of customers stay with the business. Due to the uncertainty, they agree to an earnout arrangement, structured on the following terms:

- the buyer pays a lump sum of $800,000; and

- the buyer agrees to pay the seller 50 per cent of revenue above $500,000 for the next three financial years — capped at $200,000 per year (the earnout right).
The market value estimate of the earnout right is $300,000. Thus, the seller’s total capital proceeds for the sale of the business is $1.1 million and the buyer’s cost base for the business is also $1.1 million.

Revenues for the business in the following three years are $700,000, $800,000 and $700,000. Therefore, the seller receives payments of $100,000, $150,000 and $100,000. These payments are treated as capital proceeds for the ending of the earnout right. For simplicity, assume that there are three separate rights with equal market values (and therefore cost bases) of $100,000.

**Consequences for the seller**

- Year 1: Proceeds of $100,000 minus cost base of $100,000 = No capital gain or loss
- Year 2: Proceeds of $150,000 minus cost base of $100,000 = $50,000 capital gain
- Year 3: Proceeds of $100,000 minus cost base of $100,000 = No capital gain or loss

Suppose the seller is an individual who qualifies for the small business CGT concessions and the business has a cost base of $700,000.

The seller makes a capital gain of $400,000 on the sale of the business (capital proceeds of $1.1 million minus the $700,000 cost base). The seller reduces the capital gain to $200,000 and again to $100,000 using the CGT discount and the small business active asset 50 per cent reduction respectively. The seller then applies the retirement exemption to eliminate any CGT liability on the remaining $100,000 capital gain.

The seller makes an additional capital gain of $50,000 on the earnout right, reduced to $25,000 using the general CGT discount. The seller cannot use the small business CGT concessions to further reduce or defer the CGT liability on that gain.

If the seller had instead sold the business for $1.15 million upfront, the seller could have claimed the small business CGT concessions on their entire capital gain of $450,000.

**Consequences for the buyer**

The buyer will have a cost base of $1.1 million (the upfront payment plus the estimated value of the earnout arrangement). This means that although they have actually paid $1.15 million, under the separate asset approach, they cannot include the extra $50,000 in their cost base for the business.

Following from Example 1 above, suppose that in Year 3 the performance of the business was worse than expected, with revenue of only $400,000. The seller receives nothing in Year 3 and therefore makes a capital loss of $100,000. The seller cannot carry back this loss to reduce either the $400,000 capital gain realised on the sale of the original asset or the $50,000 capital gain realised on the earnout right in Year 2.

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1 Possible CGT concessions that could have been claimed include the small business roll-over, 15-year exemption, 50 per cent active asset reduction and the retirement exemption.
3. **POLICY DESIGN OF PROPOSAL**

Broadly, this proposal will treat additional payments under a standard earnout arrangement as capital proceeds for the original business asset for the seller and adding to the asset’s cost base for the buyer. It will treat payments made under a reverse earnout arrangement as effectively a repayment of part of the capital proceeds for the sale of the original asset.

There are three main elements to this proposal. The proposed approach to each of these elements is discussed below.

3.1 **IMPLEMENTING THE LOOK-THROUGH APPROACH**

The underlying principle of the look-through approach is to ignore the earnout right and treat all payments as related to the sale (or purchase) of the original business asset.

The proposed way to achieve look-through treatment differs for standard and reverse earnout arrangements:

- For standard earnout arrangements, the proposal is the cost recovery method.² Broadly, payments are treated as related to the sale or purchase of the original asset and recognised as they become entitled to be paid.

- For reverse earnout arrangements, the proposal is the ‘repaid’ method. Broadly, this involves extending the existing repaid and recoupment rules to reverse earnout payments.

Consistent with the normal capital proceeds rules, amounts will be recognised when they become certain (that is, money or property a taxpayer is ‘entitled to receive’). The apportionment rule also applies to earnout arrangements arising from the sale of multiple assets. Payments received under an earnout arrangement will likely be apportioned to assets of uncertain value, such as the goodwill of a business.

3.1.1 **Standard earnout arrangements — the cost recovery method**

Under the cost recovery method, the seller reduces the cost base of the asset as and when amounts they are due to receive become certain (including the initial capital proceeds and subsequent payments). After the cost base is reduced to zero, the seller realises a capital gain on all further amounts. This ensures that the seller’s capital proceeds for the sale of the business asset reflect the total amount received. Any capital gain is treated as realised on the business asset and is eligible for any CGT concessions that were available for that asset.

For the buyer, payments are included in the asset’s cost base as and when the buyer pays them. This ensures that the cost base reflects the actual amount paid for the asset.

The proposal is to implement the cost recovery method by using an approach similar to CGT event E4, which reduces the cost base of interests in a trust when tax-preferred distributions are

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² The ‘cost recovery method’ commonly refers to the proposed treatment of the seller only. However, it is used more generally in this paper to refer to the treatment of both the buyer and seller in a standard earnout arrangement.
made. One option for this is to create a new CGT event that applies to earnout arrangements. Another option is to modify existing rules (such as CGT event A1).

In addition, amendments will be required to the cost base rules and capital proceeds rules in Divisions 110 and 116 respectively of the *Income Tax Assessment Act 1997* (ITAA 1997).

Example 2 uses the same facts as Example 1, but applies the proposed tax treatment. This illustrates that where there is an eventual capital gain the seller can attribute this to the original asset. In addition, the buyer’s cost base accurately reflects what they paid to acquire the asset.

### Example 2. Cost recovery method — overall capital gain

The structure of the earnout arrangement and the performance of the business is the same as in Example 1, resulting in an upfront payment of $800,000 and subsequent payments of $100,000, $150,000 and $100,000. However, in this example, the seller’s cost base for the business is $1 million. (Because the look-through approach ignores the earnout right there is no need to estimate its market value.)

#### Proposed tax treatment of seller

<table>
<thead>
<tr>
<th>Year</th>
<th>Cost base</th>
<th>Capital proceeds</th>
<th>Adjusted cost base</th>
<th>Capital gain / loss (annual)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 0</td>
<td>$1 million</td>
<td>$800,000</td>
<td>$200,000</td>
<td>$0</td>
</tr>
<tr>
<td>Year 1</td>
<td>$200,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$0</td>
</tr>
<tr>
<td>Year 2</td>
<td>$100,000</td>
<td>$150,000</td>
<td>$0</td>
<td>$50,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>$0</td>
<td>$100,000</td>
<td>$0</td>
<td>$100,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$1 million</strong></td>
<td><strong>$1.15 million</strong></td>
<td></td>
<td><strong>$150,000</strong></td>
</tr>
</tbody>
</table>

Overall the seller’s capital proceeds were $1.15 million, resulting in an overall capital gain of $150,000 realised as two separate gains of $50,000 and $100,000 (the capital gains in Year 2 and Year 3 are brought to account in the respective income year for Year 2 and Year 3). The seller will have access to any CGT concessions for the subsequent capital gains that they could access for the original capital gain.

#### Proposed tax treatment of buyer

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Paid</th>
<th>Cost base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 0</td>
<td>$800,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Year 1</td>
<td>$100,000</td>
<td>$900,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>$150,000</td>
<td>$1.05 million</td>
</tr>
<tr>
<td>Year 3</td>
<td>$100,000</td>
<td>$1.15 million</td>
</tr>
</tbody>
</table>

Applying the cost recovery method, the buyer’s cost base for the business is $1.15 million.
One implication of the cost recovery method is that the seller cannot realise a capital loss until the end of the arrangement. This avoids the high compliance costs of amended assessments, while still achieving look-through treatment. It also is consistent with the deferred realisation of capital gains when the seller makes an overall capital gain, as shown in Example 2.

Example 3 uses the same facts as Example 2 but provides an example of an overall loss. In this situation, the seller progressively reduces their capital proceeds until they realise a capital loss at the end of the earnout arrangement.

**Example 3. Cost recovery method — overall capital loss**

The structure of the earnout arrangement is the same as in Example 2. However, the performance of the business is different, resulting in an upfront payment of $800,000 and subsequent lower payments of $0, $50,000 and $100,000.

**Proposed tax treatment of seller**

<table>
<thead>
<tr>
<th>Year</th>
<th>Cost base</th>
<th>Capital proceeds</th>
<th>Adjusted cost base</th>
<th>Capital gain / loss (annual)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 0</td>
<td>$1 million</td>
<td>$800,000</td>
<td>$200,000</td>
<td>$0</td>
</tr>
<tr>
<td>Year 1</td>
<td>$200,000</td>
<td>$0</td>
<td>$200,000</td>
<td>$0</td>
</tr>
<tr>
<td>Year 2</td>
<td>$200,000</td>
<td>$50,000</td>
<td>$150,000</td>
<td>$0</td>
</tr>
<tr>
<td>Year 3</td>
<td>$150,000</td>
<td>$100,000</td>
<td>$50,000</td>
<td>–$50,000</td>
</tr>
</tbody>
</table>

Overall the seller makes a capital loss of $50,000, realised at the end of arrangement.

**Proposed tax treatment of buyer**

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Paid</th>
<th>Cost base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 0</td>
<td>$800,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Year 1</td>
<td>$0</td>
<td>$800,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>$50,000</td>
<td>$850,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>$100,000</td>
<td>$950,000</td>
</tr>
</tbody>
</table>

Applying the cost recovery method, the buyer’s cost base for the business is $950,000.

There is an exception to the general rule that the seller cannot realise a capital loss until the end of the arrangement under the cost recovery method. This situation arises where the seller will still make a loss even if they receive the maximum amount possible under the earnout arrangement.

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3 Note that for the purpose of the examples in this proposals paper, where a capital loss is made, the reduced cost base is the same as the cost base.
They can claim this loss immediately, and realise further losses as they become certain (that is, if they are not paid the maximum possible under the earnout arrangement).

Suppose instead in Example 3 that the seller’s cost base was $1.5 million. The total earnout payments are capped at $600,000 (see Example 1). Combined with the upfront payment, even in the best case scenario the seller will still realise a capital loss of $100,000.

Therefore, the seller can claim a capital loss of $100,000 in Year 0. Furthermore, every year that the earnout payment is below $200,000, the seller’s certain loss increases by the difference, and can be realised in that year. At the end of Year 1 there is no payment made, so the seller will realise a capital loss of $200,000. At the end of Year 2 the seller is paid $50,000 so they will realise a further capital loss of $150,000. At the end of Year 3 the seller receives a payment of $100,000, so at this time they will realise a further loss of $100,000. Overall the seller will have a $550,000 capital loss.

**What if the standard earnout arrangement ends early?**

Suppose that the earnout arrangement is brought to an end early — for example, if the original buyer sells the asset or if they die.

The appropriate tax outcome will depend on whether the original buyer pays an amount to the seller to end the earnout right early, sells the asset together with the obligation to pay money under the earnout right, or sells the asset but keeps the obligation.

- The buyer includes any amount paid to end the earnout right in the asset’s cost base.
- When the original buyer sells the asset together with the earnout obligation, they use the cost base at that time to calculate any capital gain or loss. This is because the price for the business with the earnout attached will be lower to reflect that the original buyer is no longer liable to pay the original seller earnout payments contingent on the performance of the business.
- However, what should happen if the original buyer sells the asset but keeps the earnout obligation? Is it possible to avoid both the need for estimating the market value of the earnout right and the need for amended assessments?

### 3.1.2 Reverse earnout arrangements — the ‘repaid’ method

For reverse earnout arrangements, subsequent payments from the seller to the buyer would effectively be treated as a partial refund. This can be implemented by making amendments to the existing ‘repaid’ rules (for sellers) and ‘recoupment’ rules (for buyers).

The repaid rules in section 116-50 of the ITAA 1997 could be amended to allow earnout payments made by the seller to reduce their capital proceeds. This would allow the seller to amend their capital gains calculation to reduce their capital proceeds from the disposal of the original asset as and when they become obligated to pay an amount to the buyer under the reverse earnout arrangement.

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4 The original sale contract may require the original buyer to not sell the asset during the earnout arrangement.
The recoupment rules in section 110-45(3) of the ITAA 1997 could be expanded to require the buyer to decrease their cost base when they recoup part of the purchase price — that is, when the buyer is entitled to payments under the earnout arrangement.

Example 4 shows how the proposed treatment will apply for a reverse earnout arrangement for both the buyer and seller. In Example 4 the capital proceeds are less than the cost base, resulting in an eventual capital loss for the seller. The seller can amend their original capital proceeds each year they make a payment under the reverse earnout arrangement. The buyer reduces their cost base for the asset as they are entitled to receive payments.

**Example 4. Repaid method — overall capital loss**

Two parties agree that a widget making business is worth at least $1.7 million, but potentially $2 million or more if the specialised widgets produced by the business are really popular. Due to the uncertainty, they agree to a reverse earnout arrangement, structured on the following terms:

- the buyer pays a lump sum of $2 million; and
- where the profit is less than $250,000 the seller agrees to pay the buyer 50 per cent of the difference for the next three financial years (the reverse earnout right).
  - For example, if the profit was $20,000 the difference is $230,000 and therefore the earnout payment is $115,000.

The profit for the business in the following three years are $20,000, $40,000 and $60,000. Therefore, the seller makes payments of $115,000, $105,000 and $95,000.

The seller has a cost base of $1.7 million.

**Proposed tax treatment of seller**

<table>
<thead>
<tr>
<th>Year 0</th>
<th>Payments / Repayments</th>
<th>Capital proceeds</th>
<th>Cost base</th>
<th>Capital gain / loss</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$2 million</td>
<td>$2 million</td>
<td>$1.7 million</td>
<td>$300,000</td>
</tr>
<tr>
<td>Year 1</td>
<td>–$115,000</td>
<td>Amend to $1.885 million</td>
<td>$1.7 million</td>
<td>Amends Year 0 capital gain to $185,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>–$105,000</td>
<td>Amend to $1.78 million</td>
<td>$1.7 million</td>
<td>Amends Year 0 capital gain to $80,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>–$95,000</td>
<td>Amend to $1.685 million</td>
<td>$1.7 million</td>
<td>Amends Year 0 to $15,000 capital loss</td>
</tr>
</tbody>
</table>
The seller must amend their tax assessment at the end of each income year in which they make (or become obligated to make) payments — in this example, at the end of Year 1, Year 2 and Year 3. At the end of the income year for Year 3 the seller makes a final amendment to their capital proceeds, to $1.685 million (and thus realise an overall $15,000 capital loss on the sale).

**Proposed tax treatment of buyer**

<table>
<thead>
<tr>
<th>Amount paid / recouped</th>
<th>Cost base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 0</td>
<td>$2 million</td>
</tr>
<tr>
<td>Year 1</td>
<td>$1.885 million</td>
</tr>
<tr>
<td>Year 2</td>
<td>$1.78 million</td>
</tr>
<tr>
<td>Year 3</td>
<td>$1.685 million</td>
</tr>
</tbody>
</table>

Under the repaid method, recoupments are deducted from the cost base of the asset when they are made. Thus the cost base for the buyer is $1.685 million.

Following from Example 4 above, suppose in the final year that the seller made a payment of $50,000 to the buyer instead of $95,000. The proposed treatment is similar to the example above, except that a capital gain will be realised in Year 3 instead of a capital loss. This means that in Year 3 the seller amends Year 0 to realise a capital gain of $35,000.

**What if the reverse earnout arrangement ends early?**

Suppose that the reverse earnout arrangement is brought to an end early — for example, if the original buyer sells the asset or if they die.

As noted in section 4.1.2, the appropriate tax outcome will depend on whether the original buyer receives a payment from the original seller to end the earnout arrangement early, sells the right to receive money under the reverse earnout right with the business, or sells the asset but keeps the right.

- The buyer reduces the asset’s cost base by any amount received to end the reverse earnout right.

- When the original buyer sells the asset together with the reverse earnout right, they use the cost base at that time to calculate any capital gain or loss. This is because the price for the business with the reverse earnout attached will be higher to reflect the potential to receive further earnout payments from the original seller.

- However, what should happen if the original buyer sells the asset but keeps the reverse earnout right? Is it reasonable to apply the cost recovery method to the original buyer — that is, treat any further payments from the original seller as if they were payments under a standard earnout arrangement from the second buyer?
3.1.3 Combined earnout arrangement

It is possible for a standard and reverse earnout to be used in the one arrangement. Example 5 shows how the proposed look-through approach will treat earnout payments in this situation.

The cost recovery method will apply to the seller when they receive payments under the standard earnout. When they make payments back to the buyer under the reverse earnout the repaid rule will apply to reduce their capital proceeds.

For the buyer, when they make payments under the standard earnout the cost recovery approach will apply to increase the asset’s cost base. When they receive payments under the reverse earnout the recoupment rules will apply to reduce the asset’s cost base.

Example 5. Combined cost recovery and repaid methods — overall capital gain

Two parties agree that a business is worth at least $4 million but potentially up to $6 million. Due to this uncertainty they use a combined earnout arrangement, structured on the following terms:

• the buyer pays a lump sum of $5 million;
• the buyer agrees to pay the seller 50 per cent of profit above $600,000 for the next four financial years (the standard earnout right); and
• the seller agrees to pay the buyer 50 per cent of profit below $400,000 for the next four financial years (the reverse earnout right).

Profits for the business in the following four years are $280,000, $450,000, $640,000 and $740,000. Therefore, the buyer receives a payment of $60,000 in the first year and the seller receives payments of $20,000 and $70,000 in the third and fourth years. There are no payments in the second year. The seller’s cost base is $4.5 million.

Proposed tax treatment of seller

<table>
<thead>
<tr>
<th>Amount received / repaid</th>
<th>Cost base</th>
<th>Capital proceeds</th>
<th>Adjusted base</th>
<th>cost base</th>
<th>Capital gain / loss (annual)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 0</td>
<td>$5 million</td>
<td>$4.5 million</td>
<td>$5 million</td>
<td>$0</td>
<td>$500,000</td>
</tr>
<tr>
<td>Year 1</td>
<td>–$60,000</td>
<td>$0</td>
<td>Amend to $4.94 million</td>
<td>$0</td>
<td>Amend Year 0 capital gain to $440,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Year 3</td>
<td>$20,000</td>
<td>$0</td>
<td>$20,000</td>
<td>$0</td>
<td>$20,000</td>
</tr>
<tr>
<td>Year 4</td>
<td>$70,000</td>
<td>$0</td>
<td>$70,000</td>
<td>$0</td>
<td>$70,000</td>
</tr>
<tr>
<td>Overall Total</td>
<td>$4.5 million</td>
<td>$5.03 million</td>
<td></td>
<td></td>
<td>$530,000</td>
</tr>
</tbody>
</table>
Applying the combined approach the seller makes an overall capital gain from the sale of the business of $530,000 (realised in three parts).

The seller only amends their assessment when they pay money back under the reverse earnout right. When they receive money under the earnout arrangement, they reduce the cost base and/or declare a capital gain as appropriate.

Thus, the seller must amend their assessment in Year 1 and reduce their Year 0 capital gain to $440,000.

### Proposed tax treatment of buyer

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount Paid</th>
<th>Amount recouped</th>
<th>Cost base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 0</td>
<td>$5 million</td>
<td>0</td>
<td>$5 million</td>
</tr>
<tr>
<td>Year 1</td>
<td>0</td>
<td>$60,000</td>
<td>$4.94 million</td>
</tr>
<tr>
<td>Year 2</td>
<td>0</td>
<td>0</td>
<td>$4.94 million</td>
</tr>
<tr>
<td>Year 3</td>
<td>$20,000</td>
<td>0</td>
<td>$4.96 million</td>
</tr>
<tr>
<td>Year 4</td>
<td>$70,000</td>
<td>0</td>
<td>$5.03 million</td>
</tr>
</tbody>
</table>

Applying the combined approach, the cost base of the business for the buyer is increased to $5.03 million.

### 3.2 Application date and transitional provisions

The proposed amendments will apply for all earnout arrangements entered into after the date of Royal Assent.

The following transitional arrangements will be available:

- Taxpayers will have the choice to apply the proposed look-through treatment for earnout arrangements entered into between the dates of announcement and Royal Assent (inclusive).

- In addition, the buyer in a standard earnout arrangement will have the choice to apply look-through treatment for arrangements entered into on or after 17 October 2007, the date of release of the draft Ruling. For arrangements entered into before this date they have the choice to rely on Tax Ruling 93/15 (which effectively provides look-through treatment by allowing payments made under an earnout arrangement to be included in the buyer’s cost base).
3.3 **INTEGRITY MEASURES**

The proposal includes integrity rules to ensure that the earnout arrangement is genuine and to minimise exploitation of the look-through treatment to avoid or artificially delay tax liabilities. These integrity rules include:

- a maximum time limit for the earnout arrangement (for example, 5 years);
- payments must be genuinely contingent and related to the performance of the asset;
- the earnout right must exist due to uncertainty about the value of one or more of the assets;
- the transaction must be at arm’s length; and
- the asset(s) is not a revenue asset or trading stock.

4. **FOCUS OF SUBMISSIONS**

Some specific questions to consider when preparing submissions include:

- The method of implementing the look-through approach for the buyer and seller in a standard earnout arrangement.
- The method of implementing the look-through approach for the buyer and seller in a reverse earnout arrangement.
- Is the transitional relief adequate?
- Are the integrity measures appropriate to ensure the look-through treatment only applies to genuine earnout arrangements?