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Tax technical paper

Selling a business: some tax issues

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Overview

This paper canvasses some of the tax issues that may arise when selling a business. In particular, a number of options are available that may meet the commercial (non-tax) goals of the parties involved. However, the tax treatment of those options may produce outcomes that are unexpected, with the potential for unintended liabilities to arise. Consequently, the tax treatment of any proposal should be properly considered before implementation in all cases.

The material presented is in two clear components: what may be regarded as relatively basic issues, in that they tend to arise in many cases, especially when the structures adopted are not designed for any particular outcome (aside from the transfer of the business); and more intermediate or advanced issues that are the subject of specific provisions.

Rather than providing an overview of how the provisions operate, particularly for the basic issues, the paper focuses on issues that the author has seen arise in practice on a number of occasions. Whether these are common mistakes or matters on which advice is sought on frequently, they represent points to bear in mind when advising on the sale of a business.

1 Introduction

This paper canvasses some of the tax issues that may arise when selling a business. In particular, a number of options are available that may meet the commercial (non-tax) goals of the parties involved. However, the tax treatment of those options may produce outcomes that are unexpected, with the potential for unintended liabilities to arise. Consequently, the tax treatment of any proposal should be properly considered before implementation in all cases.

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The material covered in the basic issues are:

- Selling assets or shares;
- General capital gains tax (CGT) issues;
- Small business CGT concessions; and
- Goods and services tax (GST).

The intermediate/advanced section of the paper covers:

- Scrip for scrip rollover (CGT);
- Treatment of earn-out agreements (CGT).

State tax matters, particularly duty (or stamp duty, depending on the jurisdiction) are not covered in this paper.

Unless otherwise noted, all legislative references are to the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997).

2 Basic Issues

2.1 Assets v Shares

Where the business has been operated through a company (and, in some cases, through a trust), consideration may be given to whether the transfer should be of the business assets or the shares in the company (the remaining commentary assumes that the business has been run through a company). The concerns are usually focused on the purchaser in this regard, however, there are situations where the vendor may seek to adopt one route or the other.

The choice usually made is to purchase assets only. This is normally driven by the purchaser by a concern to avoid any unknown liabilities. Generally, if assets are purchased, the purchaser will know about any liabilities that attach by virtue of the various registration schemes (land titles and the personal property security registration), which will constitute notice and normally require consent from the creditor for the transfer to take place.

In some cases, the choice may not be a practical option due to the nature of the industry in which the business operates. For example, a licence necessary to operate in a particular sector may attach to the entity that operates the business. This is the case, for example, with registered training organisations (RTOs). In these situations, the shares in the company will need to be transferred, rather than the assets, for the business to be sold effectively.

For the vendor, the sale of shares is almost certain to be subject to the CGT provisions (it is difficult to see how the sale of such shares could be part of a business itself and not on capital account).[1] Basic issues arising on this front are dealt with in the next section.

If the assets are sold, as well as CGT consequences, balancing adjustments realised in respect of any depreciating assets may arise.[2] Any assessable balancing adjustments are treated in the same manner as revenue receipts (as opposed to capital receipts). One consequence of this factor is that any capital losses cannot be offset against these gains. The treatment of any trading stock may need to be considered as well.[3]

It should also be borne in mind that, if the business was conducted through an entity such as a company or trust, any losses (capital or revenue) are trapped in that entity as they cannot be distributed to the principals.

For the purchaser, the price paid for any capital assets, including shares if the entity is purchased, form part of the relevant cost base.[4] Any ancillary costs, such as legal fees, may qualify as incidental costs and also included in the cost base.[5] Such expenditure would be included in the cost of any depreciating assets under Subdivision 40-C.

Of possibly greater importance to the purchaser is the availability of any carried forward losses held in the business. By acquiring all the shares in the company, the continuity of ownership test is failed.[6] To be able to access those losses in future, this requires that the company satisfy the same business test.[7] This may require some planning on the part of the purchaser, as any changes to the business after acquisition may constitute a change in business.[8] Note that any co-ordination in this respect with the vendor (such as instituting any changes to the business prior to the change of ownership) may not be effective.[9]

The remainder of the paper will focus on the situation where it has been shares that have been purchased, but most of the comments are just as applicable to an asset-only transfer with appropriate modifications.

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1 Most likely as a CGT event A1; see sec.104-10.
2 See Subdiv.40-D, particularly sec.40-285.
3 See Div.70, particularly sec.70-90.
4 See sec.110-25.
5 See sec.110-25(2) and 110-35.
6 See sec.165-12.
7 See sec.165-13.
8 For further guidance, see Ruling TR 1999/9.
9 See sec.165-210(3).

2.2 General CGT Issues

CGT Discount

Depending on when the shares were acquired, the vendor may have the choice to apply either indexation to the cost base of the shares or apply the CGT discount to any gains realised. Note that these concessions are mutually exclusive; only one may be chosen.[10]

While indexation is frozen as of 30 September 1999 and, therefore, its attractiveness is generally quite low when compared with the CGT discount, there are some situations in which it is worthwhile to consider the application of indexation. For example, if the vendor is a company, the CGT discount is not available.[11] More broadly, for vendors to whom the CGT discount is available, indexation should be considered when the vendor has capital losses to offset against any gains. Due to the procedure set out in s 102-5 for calculating the net capital gain, a more favourable outcome may arise through applying indexation rather than the CGT discount when losses are included in the calculation.

One of the eligibility requirements for the CGT discount is that the CGT asset has been held for at least 12 months.[12] The Commissioner of Taxation has released Tax Determination TD 2002/10 dealing with the precise measurement of when the 12 month holding period is satisfied. In essence, the holding period may be regarded as slightly more than 12 months, being 12 months plus one day or even plus two days, depending on your viewpoint. For instance, an example is provided in paragraph 5 of TD 2002/10, in which the taxpayer acquires an asset on 2 February 2001. To qualify for the CGT discount, the asset (as per the approach set out in TD 2002/10) cannot be sold before 3 February 2002. In effect, the date of acquisition and date of sale are excluded from the determination of whether the asset has been held for the requisite 12 months.

This position has not been challenged in the courts. Despite any misgivings as to its correctness, meeting the requirement put forward in TD 2002/10 should not be challenging with some minimal planning. Once a client has expressed an intention to sell, it is worthwhile to check the relevant acquisition date/s of any CGT assets for this purpose and ensuring that the dates align with the Commissioner’s view. The slight delay will almost always be worth the additional tax concession available. Of course, for a business that is in a position to be sold, this would normally have been held for more than 12 months, so this is unlikely to be an issue where individual assets are not being sold.

Capital Losses

As noted earlier, capital losses can be offset only against capital gains. In the situation where the vendor has carried forward capital losses from previous years, these losses may provide an effective shelter for the gain realised on sale.

In the situation where a gain is to be realised, or even has been realised (but sufficiently soon before the end of the year), the vendor may consider whether they are carrying any assets at a loss. In such cases, consideration may be given to selling such assets, which will crystallise the losses being carried, making them available to offset against the gains, as well as freeing up cash for other investment opportunities. It is this last point, though, that is especially salient; the decision to sell should be driven by commercial considerations, not tax. The particular danger is that a decision to sell based on only the

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[10] See sec.115-20.
[11] See sec.115-10.
[12] See sec.115-25.

tax treatment would be in danger of breaching the general anti-avoidance rules in Part IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936).[13]

2.3 Small Business CGT Concessions

These are contained in Division 152 and are quite generous.

The basic conditions for qualifying for these concessions are contained in Subdivision 152-A. One of these is the active asset test.[14] An asset is an active asset, broadly, if it was used as part of the business that was operated.[15] The definition is extended to include shares in the company through which the business was conducted, subject to certain restrictions.[16] To pass the active asset test, the asset must have been an active asset for the shorter of half of the ownership period or 7.5 years (if held for 15 years or more).[17]

In some situations, questions may be raised as to whether an asset passes the active asset test. This usually arises in respect of there being a sufficient connection with the business, but, at times, the length of time that the asset qualifies as an active asset may be questioned.

Another basic condition is the maximum net asset value (MNAV) test contained in s 152-15. At the time of writing, this stipulated that the taxpayer (being the vendor of the business for the purposes of this discussion) does not have assets with a net value exceeding $6 million.

Two things are important to observe regarding this test. First, it is the value of net assets, not their gross value that counts. This means that the value of any liabilities associated with those assets needs to be included in the calculation, which brings down the value recognised.[18] However, it may not always be clear whether there is a sufficient connection between the asset and liability in question; see the Full Federal Court's decision in Bell v Commissioner of Taxation. [19]

Section 152-20(2) also contains a number of exclusions from the calculation. The primary exclusions are the taxpayer's superannuation and their main residence. While in the context of small business owners, these assets, especially superannuation, may not be as substantial relatively speaking compared with most other taxpayers (since small business owners frequently have not invested much in superannuation prior to disposing of their business), they may still be significant and be the difference between the MNAV test being met and not.

An aspect that clients and some practitioners miss is that the MNAV relates not only to the instant taxpayer, but also captures the net value of any CGT assets held by the taxpayer's affiliates or entities connected with such affiliates.[20] The term "affiliate" is given the meaning applied in s 328-130, but is widened for the purposes of Subdivision 152-A by s 152-47.

The basic definition in s 328-130(1) states:

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[13] Even where the decision to sell had been made on commercial grounds, but the sale date was brought forward for tax purposes may still breach Part IVA; see sec.177D(2)(c) of the ITAA 1936. Further, a sale followed by reacquisition a short time later (sometimes referred to as a wash sale) is likely to trigger Part IVA; see Ruling TR 2008/1.
[14] See sec.152-35.
[15] See sec.152-40(1).
[16] See sec.152-40(3).
[17] See sec.152-35(1).
[18] See sec.152-20.
[19] *Bell v FCT* [2013] FCAFC 32.
[20] See sec.152-15(c).

> An individual or a company is an affiliate of yours if the individual or company acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the business of the individual or company.

Section 328-130(2) goes on to note that an individual (or company) is not an affiliate merely because of the business relationship they have with the taxpayer. In other words, something over and above the business relationship that would indicate that the individual could reasonably be expected to act in accordance with the taxpayer's wishes is required for that individual to qualify as an affiliate. For example, the mere fact that two individuals are partners in a partnership is not sufficient for those two individuals to qualify as affiliates.

As noted, this definition is extended for the purposes of the CGT small business concessions. The extension covers spouses and children (under 18 years old) in circumstances where there is an entity involved (whether the individual or an entity owned by that individual) that uses an asset in their business owned by the other individual (or entity owned by that other individual). For the purposes of this paper, it is necessary to note that the MNAV test is extended to include the assets of such spouses (and, less likely, children) where the parties may own separate concerns, but there is cross use of the assets in the other business. This is an interaction that is commonly missed and has the potential to be the difference between meeting the basic conditions and not, which determines access to the concessions.

In a similar fashion, the wider notion of affiliate is commonly missed. Where the parties involved habitually act in concert with each other, subject to the qualification noted above regarding s 328-130, then the net assets of these parties need to be taken into account when undertaking the relevant calculations. Whilst double counting is precluded,[21] the requirement to include assets held by parties other than the taxpayer is frequently overlooked and is often the difference between satisfying the MNAV and not.

Subdivision 152-E provides for rollover relief where a replacement asset is acquired. An interesting feature of the rollover is that the operative provision, being s 152-410, is misleadingly brief in the detail for the requirements of the rollover, requiring (on its face) that only the basic conditions for relief set out in Subdivision 152-A need be satisfied. There is no explicit requirement in Subdivision 152-E that a replacement asset actually be acquired or any indication in what time period such a replacement asset would need to be acquired for the rollover to apply.

However, such details are provided for in other provisions, specifically in Subdivision 104-J. In particular, CGT events J2 (s 104-185), J5 (s 104-197) and J6 (s 104-198) set out consequences where the rollover has not been satisfied once claimed, in effect providing the content to the requirements for the rollover.

The relevant period in which the rollover asset needs to be acquired is generally the three year window beginning one year before the CGT event giving rise to the rollover and two years after that CGT event.[22] This is modified in certain circumstances, such as when the disposal of the relevant CGT asset took place as part of a look-through earn-out right, which is discussed in more detail below.

One aspect of the rollover provisions or, more specifically, the CGT events arising from not implementing the rollover correctly, that is often overlooked is the need for the same

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[21] See sec.152-15(c).

[22] See sec.104-190(1A).

taxpayer to be the party that acquires the replacement asset. This arises from the wording of the operative CGT event provisions, which are all expressed in the form of "you" acquiring the relevant replacement asset, etc.

The mistake that is often made is in using a different entity to acquire the replacement asset. This arises, for example, in situations where a taxpayer may have operated a small business for a number of years in their own name (or in partnership) and, upon sale (without the intention to retire), decides to take the opportunity to restructure their business affairs. While there is some provision for an interposed entity to be placed between the taxpayer and the replacement asset (see, for example, s 104-197(2)(b) in relation to CGT event J5), this must be done carefully and precisely, otherwise an unintended tax bill may be the result.

2.4 Goods and Services Tax

The major consideration with respect to goods and services tax (GST) in the context of selling a business is accessing the going concern exemption provided for in Subdivision 38-J of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth).[23]

The operative provision for this concession is s 38-325, which permits a sale of a going concern to be GST-free where certain conditions are met.

The condition with which most practitioners are familiar is that in s 38-325(1)(c), which requires that the supplier (vendor) and recipient (purchaser) agree in writing that the supply is of a going concern. This is usually achieved through an acknowledgment in the contract of sale by ticking a marked box, as well as incorporating any necessary caveats in the special conditions.

The problem is that many practitioners believe that that is the extent of the requirement; so long as the parties to the transaction agree that the sale is of a going concern and do so via the contract, then there is nothing further to be done.

This overlooks the requirements of s 38-325(2), in particular, paragraph (a), which requires that the supplier provides as part of the sale all the things necessary for the continued operation of the going concern. While the Commissioner has indicated that a somewhat flexible view will be taken of this requirement in circumstances where it is not possible to supply something, such as due to regulatory restrictions, but that requirement for the business (such as a licence) is ultimately issued to the purchaser,[24] a strict view is taken in other circumstances.

This arises particularly where the purchaser of the business may already possess some elements necessary to operate the business. This is especially likely to arise where the purchaser has been operating in that industry previously and is acquiring this business as part of an expansion program. If the vendor does not provide all items required for the continued operation of the business, such as physical assets (which, for example, the purchaser may refuse if they already own assets that perform the same task), then this requirement will not be met and the sale will not be GST-free.

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[23] For this subsection only, subsequent legislative references are to this statute.

[24] See Ruling GSTR 2002/5 at [50].

Consequently, it is important to identify and ensure that all items necessary for the continued operation of the business are supplied by the vendor to the purchaser, regardless of the circumstances of the sale.

It should be noted that the sale of business that is a taxable supply will, in most cases, not affect the financial position of either party, since the GST paid can be claimed back as an input tax credit by the purchaser, subject to the usual requirements of registration. However, there may be a cash flow imposition, especially for the purchaser. If this imposition is sufficiently significant, then the purchaser should ensure that the vendor is providing all things necessary for the continued operation of the business to ensure that the GST-free treatment applies.

To protect itself, the vendor should ensure that the contract of sale includes a clause addressing the prospect that the GST-free treatment does not apply. In such an eventuality, the clause should ensure that the purchaser is liable to the vendor for any GST found to be payable.

Further details of how the Commissioner applies the going concern exemption are provided in GSTR 2002/5.

3 Intermediate / Advanced Issues

To this point, the substantive matters covered are fairly placed at the basic end of the spectrum. For parties not accustomed to dealing with that material, the coverage of that substance may provide some insights into overarching tax concerns arising from the sale of businesses. The primary purpose, though, was to highlight a number of areas where the author has experienced advisers have missed aspects and, thereby, potentially created unexpected problems or not qualified for concessions.

In this section, some more advanced tax aspects of selling a business are covered. As well as covering the relevant substantive tax law, this material may also provide considerations when advising clients as to how to structure the sale of their business (or when purchasing a business).

3.1 Scrip-for-Scrip Rollover

The scrip-for-scrip rollover provisions are contained in Subdivision 124-M of the ITAA 1997.

These provisions provide for a deferral of capital gains tax that would otherwise be payable where shares are exchanged for shares rather than cash. In situations where the vendor of a business may be willing to accept non-cash consideration for selling their business, specifically, a stake in the acquiring entity, this concession may provide a means by which the tax that would be otherwise payable on a sale be deferred. Where some cash is desired, but not necessarily all, a partial rollover is available for that part of the sale consideration constituted by shares.

The following discussion will focus on the situation where the business being sold was run through a company (and is being taken over by another company). The concession also extends to situations where the business was operated through a trust, which is taken over by another trust (see s 124-781).

The basic requirements are set out in s 124-780 and, in brief, are:

- The original shareholder exchanges a share (the original share) for another share (the replacement share) (this requirement is expanded to include options, rights and similar interests);
- The exchange is part of a single arrangement that:
  - Results in the acquirer acquiring at least 80% of the voting shares in the target;
  - Is one where all original shareholders had an opportunity to participate; and
  - Allowed for participation on substantially the same terms for all shareholders in a specific class;
- The original shares are post-CGT assets;
- The holder of the original share would otherwise have made a capital gain on the exchange;
- The replacement share is a share in the acquirer or its ultimate holding company; and
- The original shareholder chooses to apply the rollover.

Note that there are further requirements for non-arm's length dealing.

The consequences of the rollover being applied are set out in s 124-785. The capital gain that the original shareholder would normally have recognised upon the exchange of the shares is disregarded.[25] The first element of the new share (representing the acquisition price under s 110-25) is the amount that is reasonably attributable of the cost base of the original share as it relates to the new share.[26] This amount is adjusted where only part of the consideration received for the original shares is eligible for the rollover,[27] corresponding with the partial rollover provision in s 124-790.

The effect of the rollover is that the cost base of the original shares is substituted as the cost base for the new shares. Where the new shares are subsequently sold (and presuming another rollover is not available), the capital gain that would have been recognised at the original exchange is included in the capital gain calculated at that later time, thereby deferring the tax required to be paid. This creates the prospect of permanently deferring recognising the capital gain indefinitely if a CGT event does not occur at any time.

As noted previously, a partial rollover is available where only part of the consideration for the exchange is shares.[28] Most commonly, the ineligible part of the consideration would be cash. An additional attribution exercise needs to be undertaken in these situations to determine the portion of the cost base of the original shares that is rolled over to the new shares.

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[25] See sec.124-785(1).
[26] See sec.124-785(2).
[27] See sec.124-785(3).
[28] See sec.124-790.

One of the problems that sometimes arises is where the original shareholder seeks to place the new shares in the name of another entity, such as a nominee company. The motivation behind such a move is that the original shareholder is taking the opportunity presented through the sale of the business to, in effect, restructure the manner in which they have held their investment.

However, this approach does not meet the requirement in s 124-780(1)(a) that it is the original shareholder who must acquire the replacement share. As a result, if the shareholder places the replacement share in any name other their own, then the scrip-for-scrip rollover will not be available.

Note that there is nothing in Subdivision 124-M preventing the rollover applying to shares held by a company at the time of the rollover; that is, the rollover is not restricted only to individuals.

In the above situation, where (an individual) shareholder would like to take the opportunity presented by the takeover to establish a better holding structure for their investments, one means by which the same outcome could be achieved is using the scrip-for-scrip rollover for the initial exchange, obtaining the replacement shares in the original holder's name at this stage. This may then be followed up by transferring the replacement shares to the company that the individual intended to use as the shareholder and access the rollover concession contained in Subdivision 122-A. Of course, the requirements in Subdivision 122-A would need to be satisfied, such as the company being a wholly owned company. A further risk associated with these structures is that there are reports of the Commissioner seeking to apply Part IVA to these double rollover transactions. While no such matters have been taken to determination (AAT or court) at the time of writing, clients considering such structures should be mindful of this potential risk.

The scrip-for-scrip rollover is also sometimes used to effect an internal corporate restructure. This may be contrasted with the general business restructure rollover contained in Division 615. Note that one of these may be more suitable to a particular scenario than others, depending on the circumstances of the restructure. For example, Division 615 requires 100% of interests to be acquired, whereas Subdivision 124-M requires only 80%. The cost base of the interests exchanged is also calculated in a different manner under the different regimes and there is a differing treatment of pre-CGT interests.

3.2 Earn-out Rights

Most business sales face the inherent uncertainty of predicting future earnings. One of, if not the primary criterion for identifying an appropriate business purchase is the business' earning potential. However, such predictions of future earnings are necessarily uncertain. Even where the business, leading up to sale, has a very strong history of consistent earnings, it will normally be difficult to determine whether this success will carry over to the new owner or if it was dependent on something intrinsic to the previous owner. In the latter case, earnings could well prove to be substantially lower than they had been historically.

With this knowledge, buyers may be inclined to depress the price that they are willing to pay to allow for this uncertainty. This, in turn though, may unduly affect the vendor negatively who has built up a sustainable business independent of their own attributes, but is unable to obtain an appropriate price due to these uncertainties.

One mechanism that is often used to address these uncertainties is an earn-out right. In essence, such rights are an ancillary agreement between the parties to adjust the transfer price based on subsequent profitability. A common form of such agreement is that the price is set based on the historical earnings, but then may be adjusted downwards (the vendor refunding a part of the purchase price) if earnings are not sustained for a sufficient period (such as two or three years). Further, the purchaser may be required to pay an additional amount to the vendor if earnings are above an agreed minimum for a similar length period.

For many years, the correct tax treatment of these rights was unclear. In 2007, the Commissioner released Draft Taxation Ruling TR 2007/D10, which set out the Commissioner's view of how the general CGT rules applied to these transactions. In essence, the Commissioner would recognise the transaction in two parts. The first would be the explicit consideration for the business, whether that be in cash or property. The CGT provisions would apply as per normal.

The second component, which caused a degree of controversy within the profession,[29] was the earn-out right itself. This right was regarded as property in its own right and, therefore, as part of the consideration for the sale of the business. The capital proceeds of the sale, as worked out under s 116-20, would, therefore, include the market value of this right.[30] Similarly, the cost base of the earn-out right, which, being property, constitutes a CGT asset under s 108-5, needed to have a reasonable amount of the market value of the business attributed to it.[31] This becomes relevant when the earn-out right is satisfied, either through expiration or payment, constituting a CGT event C2 as per s 104-25.[32]

A significant problem with this approach, which was the basis of much of the concern in the profession while this draft Ruling represented the predominant view, was that it presented the same problem in a different form. The entire reason behind using earn-out rights in the first place was due to the uncertainty inherent in valuing a business based on its cash flows in the immediate term. The earn-out right was meant to resolve this problem, however, the applied tax treatment reintroduced this problem due to the need to recognise this right's market value for tax purposes. If such a market valuation could be obtained easily, the same process could have been used to value the business at the time of sale and, therefore, avoid the need for the earn-out right.

The uncertainty around the Commissioner's approach was resolved, in large part, through the introduction of Subdivision 118-I. Up until the date of effect, and for the few kinds of earn-out arrangement that do not fall within the new provisions,[33] the Commissioner's position as set out originally in TR 2007/D10 continues to apply.[34] Consequently, it is still necessary to be aware of the contents of TR 2007/D10, despite its formal withdrawal.

Effective from 24 April 2015, Subdivision 118-I sets out provisions dealing with what the legislation refers to as "look-through earn-out rights". These are defined in s 118-565 as a right where the following conditions are met:

(a) The right provides an entitlement to future financial benefits that are uncertain;

(b) The right relates to a disposal of a CGT asset;

[29] See, for example, Chris Evans, "Yearning for Earn-out Certainty" (2008) 11 *Tax Specialist* 294.
[30] See Ruling TR 2007/D10 at [13].
[31] See Ruling TR 2007/D10 at [16].
[32] Ruling TR 2007/D10 at [17]-[22].
[33] For example, an arrangement that ends more than five years after the end of the year in which the business was sold.
[34] See Notice of Withdrawal Ruling TR 2007/D10W at [4].

(c) The disposal causes CGT event A1 to occur;

(d) The CGT asset was an active asset of the seller just before the CGT event;[35]

(e) All financial benefits to be paid under the right will be paid within five years of the end of the income year in which the CGT event occurred;

(f) These financial benefits are contingent on the economic performance of the business;

(g) The value of these financial benefits relates to that economic performance; and

(h) The right is based on an arm's length dealing.

The net effect of the remaining provision in Subdivision 118-I is that, for CGT purposes, the vendor will recognise the consideration immediately received for the sale of the business, ignoring the value of the earn-out right (a significant departure from the treatment under TR 2007/D10). However, subsequent payments received under the earn-out right result in an adjustment to the capital gain (or loss) recognised at the time of sale.[36] In effect, payments received under the earn-out right are backdated and assessed accordingly. This deeming of the receipt date is important for the interaction with other provisions, such as the CGT discount under Division 115.

Similar rules are in place to deal with the situation for purchasers of the business, particularly in respect of the calculation of the cost base.[37]

Care should be taken where a look-through earn-out right (as defined) is being considered in circumstances where the small business CGT concessions may be claimed. While the provisions make allowance in some circumstances to permit access to these concessions, such as additional time to comply with rollover requirements under Subdivision 152-E, this is not universally the case. For example, the backdating of payments may result in the loss of eligibility for concessions that had previously been claimed in good faith (although no shortfall interest charge is applied in such situations).

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[35] Note the extended definition of "active asset" for the purposes of Div.118-I contained in sec.118-570.

[36] See sec.116-120.

[37] See sec.112-36.