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TAXATION IMPLICATIONS OF BUYING AND SELLING A BUSINESS

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Taxation implications of buying and selling a business

CGT small business concessions: $6m test

- $6m max net asset value test must be satisfied "just before the CGT event": s 152-15 ITAA97
- Max net asset value test proven litigious
- Comsnr can challenge valuations: see AAT Case [2011] AATA 588, *Re Venturi and Comsnr of Taxation* also Case [2011] AATA 589, *Re Syttadel Holdings*
- In *Re Venturi*, TP's valuations found to be flawed. No estimate of future earnings, valuations not made "just before CGT event" (made after ATO audit started)

Taxation implications of buying and selling a business

CGT small business concessions: $6m test

- In *Re Syttadel*, TP sold marina as a going concern for $8.9m but produced a valuation of $4.5m. AAT rejected valuation, said:

  "somewhat curious practice to adopt a market value by references to offers made and the sum at which a vendor was prepared to sell [$4.5m]. The practice is not improved by a process of separating the component parts and valuing them by reference to yield figures that, in my view, simply cannot be justified".

- See ATO Decision Impact Statement 7 Feb 2012 re valuations

- Remember: TP bears onus against Comsnr

Taxation implications of buying and selling a business

CGT small business concessions: small business entity test

- An entity will not need to satisfy the $6m net asset value test if it is a "small business entity"

- An entity is a small business entity if it:
    1. carries on a business; and
    2. satisfies the $2m aggregated turnover test

- $2m test satisfied if entity's ordinary income for previous or current year is less than $2m

- Aggravated turnover = ordinary income derived in ordinary course of carrying on a business (GST & CGT excluded)

- Turnover of affiliates/entities connected with TP included

Taxation implications of buying and selling a business

CGT small business concessions: active asset test

- CGT asset active if TP owns asset and is used/held ready for use in course of carrying on a business by TP or affiliate/entity connected with TP
- Timing rules to be satisfied: asset must be active for at least half the period of ownership starting when asset was acquired and ending at time of CGT event; different timing rules if business ceased
- Exceptions: some assets cannot be active <u>including an asset whose main use in business is to derive rent</u>
- See *Re Carson and FCT* [2008] AATA 156; holiday apartment not active asset as main use was to derive rent. See also TD 2006/78
- Further special rule applicable if shares/units to be active assets

Taxation implications of buying and selling a business

CGT small business concessions – concession s'holder test

- Previously, controlling individual required to have at least 50% of stake in company/trust where shares/units sold

- Was essentially an individual who had rights to at least 50% of the interests in a company or trust

- Restrictive - meant the small business concessions were not available where TP was a company/trust selling shares/units in another company/trust

Taxation implications of buying and selling a business

CGT small business concessions – concession s'holder test

- Controlling individual test now concession s'holder test

- Concession s'holder = significant individual (or spouse of in some situations)

- Individual will be a significant individual if they have a small business participation percentage (SBPP) in company/trust of at least 20%

- Significant individual a considerable improvement as:
  1. the 20% stake is less onerous than the 50% test; &
  2. it permits multi-tiered structures in some circumstances

Taxation implications of buying and selling a business

CGT small business concessions – concession s'holder test

- SBPP is (for a company) the percentage an entity has because of holding legal and equitable interests in shares relating to: % of voting power, % of dividend entitlements the company may pay or % of distributions of capital the company may make, directly or <u>indirectly</u>

- If percentages vary, go with smallest

- Amendments allow an individual to have a 20% stake through an interposed entity(s)

- Where interposed entity sells shares/units, CGT concession stakeholders in object company/trust (significant individual and/or spouse if they have a stake) must have a SBPP of at least 90% in interposed entity

Taxation implications of buying and selling a business

Selling shares/units - losses

- Purchasing shares/units may be attractive if company/trust has carry forward losses
- However, stringent & complex provisions in Div 165 ITAA97 may restrict when company losses can deducted
- Company required to satisfy either:
  1. continuity of ownership test; or
  2. same business test

Taxation implications of buying and selling a business

Selling shares/units - losses

- If 50% or more of shares sold, COT test likely failed
- Test period for SBT test starts immediately before COT test failed, ends at end of income yr
- SBT test satisfied if throughout same business test period, company carries on same business as it did immediately before test time

Taxation implications of buying and selling a business

Selling shares/units - losses

- SBT test failed if during test period company derives income from:
    1. a business it did not carry on before the test time
    2. a transaction of a kind it had not entered into before test time

Taxation implications of buying and selling a business

Selling shares/units - losses

- Can similarly be difficult to access prior year trust losses if control of trust transferred
- Numerous tests (inc pattern of distributions, 50% stake, control & income injection tests) in trust loss provisions to be satisfied: Schedule 2F to ITAA36
- Likely to be failed if interests in trust transferred

Taxation implications of buying and selling a business

Selling shares/units - losses

- Making a Family Trust Election provides easier access (fewer tests to be satisfied)
- However FTE not conducive to a sale of units; penal Family Trusts Distribution Tax (46.5%) if transfer outside family group (as defined)
- Some modifications to FTE made in 2007; FTE can be revoked or varied in some circumstances

Taxation implications of buying and selling a business

Selling shares/units

- Purchasing shares/units in an entity that owns pre-CGT assets may seem attractive

- Caution required!

- An asset acquired before 20 Sep 1985 deemed to be acquired post-CGT if majority underlying interests of entity change after 20 Sep 1985: Div 149 ITAA97

Taxation implications of buying and selling a business

Selling shares/units

- Majority underlying interests = > 50% beneficial interests that ultimate owners have in assets/income from asset

- TP taken to have acquired asset at time of disqualifying change for MV

- Exceptions for death of TP or roll-over pursuant to Subdiv 126-A (marriage breakdown)

- Modified test for public entities

Taxation implications of buying and selling a business

Sale of business assets

What are the assets? Critical to answer:

a) Real property?
b) Goodwill?
c) Depreciables?
d) Trading stock? and/or
e) Intellectual property?

Treatment depends on distinction between capital and ordinary revenue

Taxation implications of buying and selling a business

Business assets: real property and goodwill

- Major assets
- May be on capital account
- Depends on activities of taxpayer

Taxation implications of buying and selling a business

Business assets: depreciating assets

- Regulated by capital allowance provisions: Div 40 ITAA97
- On revenue account; generally excluded from CGT
- Balancing adjustment event tipped into assessable income
- Unlikely to increase in value

Taxation implications of buying and selling a business

Business assets: depreciating assets

- Limited roll-over relief available for:
  - disposal to wholly owned company; and
  - marriage breakdown
- Roll-over relief available where new asset acquired as a result of involuntary disposal

Taxation implications of buying and selling a business

Business assets: trading stock

- Regulated by Div 70 ITAA97
- Gains/losses on revenue account
- Disregarded for CGT provisions
- Opportunity to convert asset held on capital account into trading stock and crystallise capital gain? (s70-30 ITAA97 & CGT event K4 (s104-220 ITAA97))

Taxation implications of buying and selling a business

Trading stock & CGT: example

- A owns large block of land on capital account
- A decides to subdivide land into 8 lots and build townhouses for sale
- If trading stock election made, land taken to have been disposed of and reacquired for either its cost price or MV (choice of TP)

Taxation implications of buying and selling a business

Trading stock & CGT: example contd

- Choose MV
- CGT event K4 applicable
- Consider if any CGT concessions available
- Outgoings on revenue account

Taxation implications of buying and selling a business

Business assets: intellectual property

- Includes patents, registered designs and copyright (not trademarks)
- Treated as depreciating assets: any gain on revenue account
- Solutions: sell the shares/units??

Taxation implications of buying and selling a business

Restrictive covenants/Restraint of trade

- Caution required

- CGT Event D1 – may be on capital account, but excluded from 50% CGT discount that may be applicable to other assets

  Example

  - A sells business
  - Restraint of trade clause - $20,000 allocated
  - Incidental costs = $1,500 (solicitors fee)
  - Capital gain = $18,500
  - No 50% discount available

Taxation implications of buying and selling a business

GST - basics

Ascertain whether a taxable supply will be made:

1. supply for consideration;
2. in the course/furtherance of an enterprise;
3. connected with Australia; and
4. supplier registered/required to be registered

Taxation implications of buying and selling a business

GST - basics

- Entitlement to an input tax credit?
- Creditable purpose
- GST-free and input taxed supplies

Taxation implications of buying and selling a business

GST – supply of a going concern

Subdiv 38-J GST Act: supply of a going concern GST-free if:

1. supply made for consideration; and
2. recipient registered/required to be registered; and
3. supplier and recipient agree in writing that supply is of a going concern

<u>All</u> of above requirements to be met

Taxation implications of buying and selling a business

GST – supply of a going concern

Writing requirement: see *Re Midford v DCT* [2005] AATA 623, *Re Nitram Consulting v Commissioner of Taxation* [2008] AATA 1119, *YXFP v Commissioner of Taxation* [2009] AATA 805

Supply of a going concern = the supply of an arrangement under which:

a) supplier supplies to the recipient all things that are necessary for the continued operation of an enterprise; and
b) the supplier carries on, or will carry on the enterprise until the day of the supply

Taxation implications of buying and selling a business

GST – supply of a going concern

- Commsnr's views in GSTR 2002/5
- Fact contract states supply is a going concern not mean it necessarily is
- Is everything capable of being supplied?
  - Leases – periodic tenancy capable of assignment;
  - Licenses, statutory permits etc

Taxation implications of buying and selling a business

GST – supply of a going concern

- Supply of shares in and of themselves not qualify under Subdiv 38-J; input taxed. See GSTR 2002/5

- Vendor to supply everything necessary for the contd operation of enterprise: see para 72 GSTR 2002/5

- Things supplied that are not necessary for the contd operation of business not qualify under Subdiv 38-J

- Enterprise to be carried on until day of supply; not qualify under Subdiv 38-J if cease prior. See *Aurora Developments v FCT* [2011] FCA 232

Taxation implications of buying and selling a business

GST – supply of a going concern

- In *Aurora*, TP acquired land with intention of developing into residential housing; then abandoned project in favour of sale of land
- Contract specified land to be GST-free on basis of going concern exemption, enterprise defined to be "enterprise of the development of the land"
- TP required to perform earthworks prior to settlement

Taxation implications of buying and selling a business

GST – supply of a going concern

- Held: by FCA that TP did not supply land as a going concern

- TP in business of property development but came to end when signed the contract. Supply made at settlement

- Purchaser had its own plans; earthworks undertaken by TP not a continuation of its enterprise but purchasers

- See ATO Decision Impact Statement of 9 Jan 2012

Taxation implications of buying and selling a business

GST – supply of a going concern

- Benefit of the exemption
- If purchaser registered, sell subject to GST? But stamp duty and time involved in claiming ITC. Tax invoice required
- Risks of the going concern exemption:
  - supplier (vendor) carries the burden of showing the sale is of a going concern
  - if ATO finds GST payable, vendor responsible
  - seek price plus GST clause if vendor?

Taxation implications of buying and selling a business

GST – supply of a going concern

- GST indemnities from purchaser – how effective are they? Penalties and GIC/SIC?

- private ruling may be worthwhile: but time consuming; delay the sale?

- If not registered, and subject to GST, absolute cost to purchaser

Taxation implications of buying and selling a business

Stamp duty

- Duty charged on transfer of dutiable property: s 7 *Duties Act* 2000
- Dutiable property includes estate in fee simple: s 10(1)(a)
- Dutiable property also includes goods in Victoria if the subject of an arrangement that includes a dutiable transaction over an estate in land elsewhere referred to in this section but not include:
  - goods that are stock in trade
  - materials held for use in manufacture

Taxation implications of buying and selling a business

Stamp duty

- goods under manufacture
- goods held/used in connection with primary production
- livestock

Taxation implications of buying and selling a business

Stamp duty

- Dutiable transactions relating to separate items of property referred to in s 10(1)(a) or (d) or s 10(1)(e) as it relates to dutiable property referred to in s 10(1)(a) or (d) are to be aggregated and treated as a single dutiable transaction if (s 24 *Duties Act*):
  - for dutiable transactions that are transfers, the contracts of sale are entered into within 12 months; or
  - the dutiable transactions occur within 12 months; or
  - the dutiable transactions together form, evidence or give effect to what is substantially one arrangement

Taxation implications of buying and selling a business

Stamp duty

- Transactions not to be aggregated if Commissioner satisfied that would not be just an reasonable to do so: s 24(2)

- Also note Revenue Ruling DA 029: where land and business sold, valuation pursuant to s 273 required if:

  - land and concurrent sale of business sold for in excess of $1m

  - transfer land with prior or subsequent sale of business within 12 months of land transfer where consideration exceeds $1m

Taxation implications of buying and selling a business

Stamp duty

- it is proposed to transfer the business within 12 months of the land transfer or there is an option to do so

- some of the parties are associated, the transaction relates to fractional interests in the property or the declared value of the property does not reflect the MV in view of municipal capital improved value

- any other circumstances the Commsnr considers it necessary

Taxation implications of buying and selling a business

Stamp duty

- Finally, narrow exemption in s 22B *Duties Act*. It effectively states that in determining the unencumbered value of land transferred, the value of business goods is to be disregarded if:

  - estate/interest in land referred to in s 10(1)(a) is transferred to a person under a contract of sale; and

  - business goods relating to that land are sold to another person under a contract of sale of goods/business; and

Taxation implications of buying and selling a business

Stamp duty

- land transferee and goods transferee are not associated; and
- Commsnr satisfied that both sales are not substantially one arrangement; and
- at least one of the contracts is conditional on the other

Taxation implications of buying and selling a business

Stamp duty - land rich provisions

- Transfer of share/units in a trust scheme that listed for quotation on ASX/recognised stock exchange are not dutiable property (section 10(2) *Duties Act*)

- Transfer of share/units in private companies/trusts post 1 Jul 2002 is not a dutiable transaction (section 7(3A) *Duties Act*)

- BUT: transfer of shares in a private company or unit trust could still attract land rich duty if company or trust is land rich

Taxation implications of buying and selling a business

Stamp duty - land rich provisions

- Provisions apply to a "landholder" that has both:
  - land holdings in Vic with an unencumbered value of $1m or >; and
  - land holdings in all places comprise 60% or more of unencumbered value of all its property.

- A landholder is any of the following:
  - a private unit trust scheme;
  - a wholesale unit trust scheme; or
  - a private company (not listed on the ASX)

- See definitions in *Duties Act*

Taxation implications of buying and selling a business

Stamp duty - land rich provisions

- When a "relevant acquisition" is made
- Relevant acquisition = acquisition of interest in land that is a "significant interest"
- A "significant interest" acquired if person, in the event of a distribution of all the property of the landholder immediately after the interest was acquired, would be entitled to:
  - in the case of a private unit trust scheme, 20% or > of the property distributed; or
  - in the case of a landholder other than a private unit trust scheme, 50% or more of the property distributed

Taxation implications of buying and selling a business

Stamp duty – land rich provisions

- Land rich provisions to be reformed by new land holder model from 1 July 2012

- 60% landrich test removed

- $1m (no increase) landholding in Victoria test for landholdings remains

- Maintenance of 20% for unlisted trusts and 50% for unlisted companies

- Just and reasonable discretion removed

Taxation implications of buying and selling a business

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Taxation implications of buying and selling a business

Introduction

- Main focus on selling a business; more immediate tax consequences
- Main focus on income tax/CGT
- To a lesser extent GST: going concern exemption

Taxation implications of buying and selling a business

Introduction

Tax implications of buying and selling a business depend on:

- what is being sold; and
- by what entity.

Concessional tax treatment afforded to some assets and some entities only

Taxation implications of buying and selling a business

Sell assets or shares/units?

Two ways of selling a business:

1. sell the shares or units (where business owned by company or trust); or
2. sell business assets

- Assets usually sold

- Risks/difficulties for purchasing entity (shares or units)

Taxation implications of buying and selling a business

Income or capital

- Taxable income = assessable income – deductions: s 4-15 ITAA97
- Assessable income includes capital gains
- Character of the gain - distinction between income and capital?
- Tax legislation offers concessions to some capital gains (but not ordinary revenue)
- Capital gains can sometimes be discounted <u>before</u> being included in assessable income

Taxation implications of buying and selling a business

CGT

- Discounts that may be available for capital gains are:
  1. 50% "passive" discount; and
  2. up to 4 small business CGT concessions

- 50% discount on unindexed gain available to individual or trust; 33.3% discount for complying superannuation funds

- Not available to companies (unless act solely as trustee)

- Asset to be held for clear 12 mths prior to CGT event

- Alternative is indexation - rarely produces a better result

- Some CGT events not qualify for 50% discount, eg CGT event D1 (creation of contractual rights)

Taxation implications of buying and selling a business

CGT small business concessions

In addition to the 50% discount, the following four small business CGT concessions may be available:

1. small business 15-year exemption;
2. small business 50% reduction;
3. small business retirement exemption; and
4. small business roll-over

Legislative changes in 2007 and 2009 introduced <u>major</u> changes to CGT small business concessions

Law in Div 152 difficult and precise; disputes with the Comsnr finding their way to FCA/AAT

Taxation implications of buying and selling a business

CGT small business concessions

- 15-year exemption a complete exemption; if it applies, no other CGT small business concession will

- 15-year exemption only applies if TP 55 years or > at time of event and event happens in connection with retirement or is permanently incapacitated at that time

- If 15-year exemption not apply, taxpayer can choose which other concessions are applicable

- In <u>all</u> cases basic conditions to be satisfied

Taxation implications of buying and selling a business

CGT small business concessions

- If not qualify for 15-year exemption, may qualify for small business 50% reduction, retirement exemption or small business roll-over
- TP has choice of selection; benefit of 50% reduction may be lost with company/trust
- Retirement exemption results in amount chosen being disregarded. Max lifetime limit of $500,000 per CGT concession s'holder. If taxpayer less than 55 years, to be paid into a complying superannuation fund
- Small business roll-over enables taxpayer to choose another active asset and roll-over the capital gain

Taxation implications of buying and selling a business

CGT small business concessions

- Unlike 50% discount, small business concessions may be used by *any* entity (if basic conditions satisfied)
- Small business concessions may apply to disposal of business assets or shares/units

Taxation implications of buying and selling a business

CGT small business concessions

- Following basic conditions must be satisfied by TP to access <u>any</u> of the small business concessions:
  - $6m maximum net asset value test; <u>or</u>
  - small business entity test;

  <u>and</u>

  - active asset test; <u>and</u>
  - concession s'holder (significant individual) if asset a share/unit

Taxation implications of buying and selling a business

CGT small business concessions: $6m test

- $6m max net asset value test requires that net value of CGT assets owned by TP and certain affiliates/entities connected with TP does not exceed $6m (previously $5m)

- Net value of assets = MV less liabilities related to assets & certain provisions

- Certain assets excluded (personal use assets, individual TP's dwelling, life insurance policies, some annuities etc)