SALE AND PURCHASE OF BUSINESS WORKSHOP

Tax Issues Arising from Business and Share Transactions

Kevin Munro
Munro Lawyers
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1. Introduction

In this commentary I will only be concerned with the situation where a company owns and conducts a business. Namely, the commentary is not concerned with alternative business structures – as it assumes one form of structure being a corporate entity carrying on the business. I have also merely considered the situation where the shareholders are individuals (or trusts in specified situations).

The first major issue for the advisor acting for the vendor clients is to decide whether to sell the business assets (the company as vendor) or to sell the shares in the company (the shareholders as vendors). There can be significant differences in the after tax position for such clients depending on the choice made.

For the purchaser that choice from a tax perspective (leaving aside the commercial issues) generally should not make too much difference – though stamp duty could be significantly different if a NSW business.

Having confined the paper as described I will attempt to:

(a) discuss the capital gains tax (**CGT**) concessions for the sale of businesses;
(b) consider the different tax consequences of the sale of business assets as compared to the sale of shares in the company owning and conducting the business;
(c) consider tax treatment of earnout provisions
(d) summarise the tax issues for vendors;
(e) summarise the tax issues for purchasers.

2. CGT Concessions

(i) Division 115 – Discounted Capital Gains

The Australian tax legislation includes capital gains within the income taxing provisions. In essence, other than specific exclusions such as a main residence, all transactions are exposed to

CGT. Where a transaction is exposed to CGT and income tax then the CGT amount is reduced by whatever amount is included under the income tax provisions.

Accordingly, for an individual the rate of tax applying in respect of CGT is that individual's personal marginal rate of tax. As a consequence, the tax rate could be as high as 45% plus medicare levy. However, a discount can apply in the case of an individual for CGT where the capital gain results from an asset held for more than 12 months (Division 115 of the <u>Income Tax Assessment Act, 1997</u> (**ITAA 1997**)). That discount is 50%. That is, the top rate of CGT for any individual taxpayer (provided the asset is held for more than 12 months) is 22.5% plus medicare.

On the other hand, if a company makes a capital gain, then the Division 115 concession is not available. That is, the tax rate applying to a capital gain made by a company is the same rate as applies to income derived, namely a flat rate of 30%. This creates a bias away from using a company to hold assets which are likely to produce a capital gain.

Certain gains are excluded from being treated as discount capital gains. Section 115-40 prevents a capital gain from being a discount capital gain if the CGT event occurred under an agreement made within 12 months of acquiring the CGT asset. This section deals specifically with options and other similar arrangements. If the contract disposing of the asset was as a result of the exercise of an option, and the option was entered into within 12 months of acquiring the asset, then no matter how long the asset was actually held, the Division 115 concession will not be available.

Another 'anti-avoidance' provision is section 115-45 of the ITAA 1997. The purpose of this section is to deny a taxpayer a discount capital gain on a share in a company if the taxpayer would not have had discount capital gains on the majority of CGT assets underlying the share in the company. This section is to stop persons having a number of companies sitting on the shelf and maturing for 12 months, using those companies to acquire short term investments, and then selling the shares of those companies and claiming the Division 115 discount.

In the case of private companies, since they do not have an entitlement to use Division 115 then indexation is still relevant where the asset sold (for example, the goodwill in the business) was acquired (or commenced) between 20 September 1985 and 20 September 1999. For such assets the indexation factor only applies up to 20 September 1999.

(ii) **Pre-CGT Assets**

Note that any asset acquired (or in the case of goodwill of a business, commenced or acquired) prior to 20 September 1985 is treated as a so-called "pre-CGT asset" and is not subject to CGT.

As in life, there are exceptions to this rule. Namely, it is not recommended to assume that an asset of the company or a share in the company are pre-CGT assets even though on the face of the situation it appears that the asset (or share) was acquired before the introduction of CGT. Certain pre-CGT shares can be deemed to be post-CGT shares where there have been fundamental changes in the assets held by the company (for example where the post-CGT assets represent 75% or more of the net asset value of the company – see CGT event K6).

A further example is that certain pre-CGT assets owned by say a company will be deemed to be post-CGT assets where there has been a change in ownership of the shares in the company of 50% or more – see Division 149 of the ITAA 1997.

(iii) Division 152 – Small Business Capital Gains Tax Concessions

Division 152 of the ITAA 1997 contains the small business capital gains tax reliefs. The criteria are:

(a) a CGT event happens to a CGT asset of the taxpayer;
(b) the event would have resulted in a capital gain for the taxpayer;
(c) the taxpayer satisfies the maximum net asset value test or a small business entity for tax purposes; and
(d) the CGT asset satisfies the active asset test.

Maximum Net Asset Value Test

A taxpayer satisfies the maximum net asset value test, if, just before the time of the CGT event (for example, entering into the agreement to sell), the sum of the following amounts does not exceed $6 million:

(a) the net value of CGT assets of the taxpayer;
(b) the net value of CGT assets of any entities connected with the taxpayer; and
(c) the net value of the CGT assets of any CGT affiliate of the taxpayer or entities connected with any CGT affiliate of the taxpayer.

The assets excluded from the net asset value test are the principal residence and benefits held in superannuation. However, the assets included in the test look at so-called “connected entities”. In essence, a connected entity is one where the individual directly or indirectly has “control”. Control being defined as 40% or more interest. That is, if a shareholder has say a 50% shareholding in a company with a value of $10 million then the value to be included in the net asset value test for that shareholder is $10 million (and not his true equity of $5 million).

Small Business Entity Test

An alternative test to the net asset value test is the so-called “small business entity test”. The threshold under this test is for the entity to have a gross turnover of less than $2 million. As with the other test, it is necessary to “group” connected entities in determining whether the threshold is met. The turnover test allows low profit highly capitalized businesses to meet the CGT concessions. A typical example is primary production. In such cases it is possible for a very high value enterprise (greater than $6 million) to meet the requirements provided the annual turnover is less than $2 million.

Active Asset Test

An asset is "active" if used in a business for at least half the time during the period in which the asset was owned or, if the asset has been owned for more than 15 years, for 7.5 years, whichever is the lesser period.

Generally, an asset is an active asset if the taxpayer owns it, and it is used, or held ready for use, in the course of carrying on a business, or is an intangible asset inherently connected with the business, such as goodwill. However, certain assets held by a connected entity but used in the course of carrying on a business can also qualify as active assets – an example is real estate such as a commercial office or factory owned by a family trust that is rented to the company carrying on the business.

Shares as Active Assets

A further important inclusion as an active asset are shares in a company (for example, the trading entity). Namely, a share in a company qualifies as an 'active asset' if the following two conditions are met:

(a) the 80% active asset test; and
(b) the CGT concessional stakeholder test.

Under the '80% active asset test', the market value of the active assets of the company must be 80% or more of the market value of all the assets of the company. Active assets include any cash or financial instruments of the company that are inherently connected with its business.

A CGT concessional stakeholder is defined in section 152-60 of the ITAA 1997 as a 'significant individual' in the company or the spouse of a significant individual in the company. An individual is a significant individual in a company if, at that time, the individual has a small business participation percentage (that is, a direct or indirect interest) in the company of at least 20% (relating to an entitlement to income, voting and equity).

(iv) **The Small Business CGT Concessions**

Once the minefield of all of the conditions and definitions are satisfied, the following concessions available under Division 152 are:

(a) the 15-year exemption;
(b) 50% active asset reduction;
(c) retirement exemption; and
(d) roll-over relief.

The 15-Year Exemption

The 15-Year Exemption provides taxpayers with an opportunity to disregard a capital gain from an eligible CGT event in its entirely. If eligibility for the 15-Year Exemption is achieved, the remaining concessions are irrelevant.

For a company to be eligible for the 15-Year exemption, in addition to meeting the basic criteria discussed above, the following must also be satisfied:

(a) the company must have owned the CGT asset (for example, the goodwill in the business being sold) continuously for at least 15 years prior to the sale of the business;

(b) the company must have had a 'significant individual' (namely, a shareholder with 20% or more shareholding) for at least 15 years during the period of ownership – the significant individual does not have to be same person in each year; and

(c) an individual who was a significant individual of the company just before the sale of the business was 55 years of age or over and the sale of the business happens in connection with the individual's retirement.

For an individual selling shares in a company (that carries on the business) to be eligible for the 15-Year Exemption, in addition to meeting the basic criteria, the following must also be satisfied:

(a) the individual must have owned the shares continuously for at least 15 years prior to the sale of the company occurring;

(b) the company must have had a significant individual for at least 15 years during the period of ownership – the significant individual does not have to be same person in each year;

(c) the individual is 55 years of age or over at the time the CGT event occurred; and

(d) the CGT event happens in connection with the individual's retirement.

The Active Asset 50% Reduction

The Active Asset 50% Reduction applies to reduce an eligible capital gain by 50%. The concession applies unless the taxpayer makes an election not to use it. It can be used by individuals in conjunction with the 50% CGT discount to reduce the assessable amount of an eligible capital gain to 25% (before consideration of the remaining concessions).

The 50% reduction is also available for companies, but extracting funds that relate to the exempt component can create further CGT events and, accordingly, tax exposure.

The Retirement Exemption

Despite the title, there is no requirement for the taxpayer to retire as a result of the relevant CGT event. If the eligibility criteria are satisfied, the capital gain will be exempt, subject to a lifetime limit of $500,000.

For individuals, if under the age of 55, the taxpayer must make a contribution equal to the exempt amount into a complying superannuation fund or a retirement savings account (“RSA”). Otherwise, the amount can be retained by the individual without any tax consequences.

Companies can also use the Retirement Exemption. In such cases, the payment is either made to the CGT Concession Stakeholders (if at least 55 years) or made as a contribution to a complying superannuation fund on behalf of the CGT Concession Stakeholder.

The Small Business Roll-over

Where the Small Business Roll-over is chosen, the taxpayer has 2 years to acquire a replacement active asset.

3. Sale of Shares in the Company or Sale of Business Assets by the Company

This part of the paper only considers the tax consequences when comparing the choice of either selling the company that operates the business as against the sale by the company of the business assets. There are many other factors that need to be considered both from the vendor’s perspective and the purchaser’s perspective.

Obviously, for example, a purchaser is reluctant to acquire shares in an existing company that operates the business as the purchaser effectively inherits the commercial risks connected with the past activities of that company. Such risks can be addressed by appropriate indemnities and warranties however recoverability under such matters is not without issues.

There are strong reasons for tax purposes for a vendor to want to sell the shares in the trading company as compared to selling the assets of the company. Against this desire is probably an unwillingness for purchasers to want to inherit the commercial risks of buying the operating company.

(i) **Example 1: Husband and wife owned company**

The following example is designed to show the tax advantages of a vendor selling its shares in the company rather than the company selling the business.

A husband and wife hold one $1 share each in the capital in a private company ('Trading Co'). The goodwill in the business conducted by Trading Co has been conducted for 10 years and is to be sold for a capital gain of $4,000,000. If Trading Co sells the business then the CGT consequences are (assuming Trading Co meets either the net asset value test or the turnover test):

Capital Gain	$4,000,000
Division 115 discount (not available)	–
Division 152	
15 year exemption (not applicable)	–
50% active asset reduction (note 1)	($2,000,000)
Retirement exemption (note 2)	($1,000,000)
Capital gain	$1,000,000
Tax at 30%	$300,000

Notes:

1. Trading Co can claim the 50% active asset reduction but that amount of $2,000,000 is then "trapped" in the Company. The amount could be retained in the company and invested; alternatively, it could be paid as unfranked dividend and taxable at the marginal rates of tax of the shareholders. A third option is to liquidate Trading Co. In that case the $2 million is treated as a capital gain to the shareholders and further tax paid.
2. As both husband and wife are significant individuals and so-called CGT concession stakeholders then the retirement exemption up to an amount of $500,000 per shareholder is available. This is paid out of Trading Co without further tax.

If the vendors could convince the purchaser to acquire the 2 shares held in Trading Co rather than the business, then the CGT consequences are:

	Husband	Wife
Capital Gain	$2,000,000	$2,000,000
Division 115 discount	($1,000,000)	($1,000,000)
Sub total	$1,000,000	$1,000,000
Division 152		
50% active asset reduction	($500,000)	($500,000)
Sub total	$500,000	$500,000
Retirement exemption	($500,000)	($500,000)
Taxable income	**Nil**	**Nil**

The shareholders between them have $4 million cash or, alternatively, $3 million cash and $1 million in superannuation. No further tax is payable.

The comparison in this example is stark. A sale of shares is so much more advantageous for the vendors from a tax point of view.

What then is the position of the purchaser if it acquires the shares in Trading Co rather than the business assets?

One tax disadvantage to the purchaser is that the cost base of the business goodwill owned by Trading Co will remain at a nil amount. By acquiring the shares the cost of the assets owned by Trading Co remain the same as when the vendors owned the company. This issue can be overcome by the purchaser using as the acquiring entity another company ('Holding Co'). In such cases if Holding Co finishes up with 100% of the shares in Trading Co then the two companies can form a tax consolidated group (treated as one tax entity). This can result in a readjustment of the cost base of assets held by Trading Co up to the market values. In addition, once a consolidated group then Trading Co can be liquidated and all assets (the business) transferred to Holding Co without any exposure to tax. That is, the purchaser can achieve a position equivalent to the situation that would have arisen if instead of buying shares it purchased the business assets.

Given the CGT concessions available to the vendor, if a purchaser cannot be convinced to acquire the shares in trading Co then it is in many cases a worthwhile exercise for the vendor to restructure the company so that it can be sold. For example, prior to the sale of the business by Trading Co, the husband and wife could transfer their shares to a new company and trigger CGT. If the vendors elect tax consolidation as discussed in the previous paragraph then Trading

Co will have the benefit of an adjustment (step-up) in the cost base of the goodwill for tax purposes. Namely, the business assets could then be sold by Trading Co to the purchaser without a CGT consequence for Trading Co (as the sale price would then be the same as its cost base. Note that tax has not been avoided – rather the tax trigger happens with the sale of the shares by husband and wife to their new company.

Note

It is strongly recommended that clients consider the above option where the value of the business is growing. That is, a client may currently meet the net asset value test or the turnover test but if left until an ultimate purchaser comes along then the value of the business may be such that these tests are not met. By restructuring as suggested in the previous paragraph the clients could achieve a step up in cost base of the goodwill of the business without CGT exposure (because of the small business CGT concessions).

(ii) **Example 2: Company fails small business CGT threshold tests**

Generally speaking, where a company that conducts a business fails to meet the small business CGT concession thresholds (net asset value teat or the turnover test as discussed above) then you would expect that the shareholders in that company would also fail the tests. That is, there may not be any major tax advantage of selling shares in the company as compared to selling the business assets by the company.

The above comment however may not always be true. The issue comes down to reviewing the position of each shareholder particularly where the shareholders are unrelated.

Take the example of a company conducting a business and the value of the business is say $9 million (namely, greater than the $6 million net asset value test) and with an annual turnover in excess of $2 million. This company does not meet the thresholds for the small business CGT concessions. As a result if the business was sold by the company for say $9 million capital gain then the entire gain would be subject to tax at 30% rate. The after tax proceeds would then be applied to the shareholders as a franked dividend with top-up tax possibly applying (in other words, the final tax rate on the gain of $9 million could be 47%).

In the above example assume that there are 3 shareholders, Smith with 50%, Jones with 30% and Brown with 20%. I have assumed that Smith, Jones and Brown are not connected entities for tax purposes (with individuals, connected entities are effectively confined to spouses and minor children). What would be the tax position if instead of the company selling the business the shareholders sold their shares in the company for $9 million (resulting in a total capital gain of $9 million)?

Smith has 50% shareholding so in determining whether he meets the threshold tests for the small business CGT concessions he needs to include the value (and turnover) of connected entities. The company in this case will be a connected entity of Smith as he holds 40% or more of the shareholding. Accordingly, Smith would fail the threshold tests and not be able to utilize the concessions. However he would still gain the benefit of the 50% discount under Division 115. That is, his gain is $4.5 million (50% of $9 million) and the taxable amount would be $2.25 million after the discount is applied. Smith will be better off selling shares rather than having the company selling the business.

Jones and Brown both have at least 20% shareholding but less than 40%. The fact that they each hold at least 20% shareholding means they are both 'significant shareholders' for the small business CGT concessions. In determining their thresholds the fact that they hold less than 40% shareholding means that the company is not a connected entity. In calculating their net asset value threshold for example they only need to include their equity value in the company (Jones with $2.7 million and Brown with $1.8 million). Assuming their remaining assets do not cause them each to exceed the $6 million test then each meets the requirements of the small business CGT concessions.

The tax calculations for Jones and Brown would then be

	Jones	Brown
Capital Gain	$2,700,000	$1,800,000
Division 115 discount	($1,350,000)	($900,000)
Sub total	$1,350,000	$900,000
Division 152		
50% active asset reduction	($675,000)	($450,000)
Sub total	$675,000	$450,000
Retirement exemption	($500,000)	($450,000)
Taxable income	**$175,000**	**Nil**

The sale of shares option is unquestionably superior result from a tax point of view. All 3 shareholders benefit with Brown for example possibly saving approximately $840,000 in tax.

4. Tax treatment of Earnout Provisions

It is not uncommon on the sale of a business or shares in the company conducting the business for the consideration to include a lump sum as well as an additional amount which is contingent on future economic performance (an "earnout" arrangement). Unfortunately, the tax treatment of such arrangements has been uncertain. If acting for a vendor it is important to understand the concepts involved.

In Taxation Ruling TR 93/15 (now withdrawn), the Commissioner expressed the view that the earnout right is a separate asset. The market value of the right is included in the capital proceeds received for the disposal of the original asset and is taken to be the cost base of the right. The eventual expiry or satisfaction of the right is a separate CGT event. This treatment of earnout arrangements created significant problems for vendors as CGT exposure would be triggered despite the part non receipt of cash proceeds.

On 17 October 2007 the Commissioner withdrew TR 93/15 and released Draft Taxation Ruling TR 2007/D10. The draft ruling unfortunately did not resolve the issues and in fact added to the confusion.

As a consequence, the Government announced a proposed change to the taxation treatment of earn-out arrangements. In brief, proceeds received pursuant to an earnout arrangement were proposed to be treated as proceeds relating to the underlying asset, and the proceeds as received brought to account.

The proposed amendment is a welcome improvement to the current taxation treatment of earnout arrangements. The current approach can be summarised as follows:

- For standard earnout arrangements, the proceeds from the sale of the relevant assets include the lump sum amount plus the estimated value of the earnout right. The problem with taxing the market value of the earnout right is that the seller must pay tax on an amount not yet received. A second problem is that valuing an earnout right at the time of sale is an imprecise and potentially costly exercise.

- When a standard earnout payment is subsequently received by the seller, a second CGT event is triggered because a payment is taken to be received for the cessation of the earnout right (i.e. a CGT event C2). This is where a third problem presents, because any capital gain under this second CGT event will not qualify for the small business CGT concessions. A fourth problem will arise if this second CGT event gives rise to a loss for the seller, because the seller cannot carry the loss back and offset it against any gain that may have arisen on the initial sale of the business if the sale occurred in a previous income year.

The proposed amendments will apply to all earnout arrangements entered into after the date of Royal Assent for the enacting Bill, with transitional provisions to be made available in certain cases with effect from 17 October 2007.

The ATO has made available the following transitional administrative arrangements:

- Taxpayers will have the choice to apply the proposed "look-through" treatment for earnout arrangements entered into between 12 May 2010 and the date that the enacting Bill receives Royal Assent.

- In addition, the buyer in a standard earnout arrangement will have the choice to apply the look-through treatment for arrangements entered into on or after 17 October 2007.

- However, the ATO will require any taxpayers who use the transitional arrangements to review their tax positions once the outcome of the proposed amendments is known.

The proposed changes are a simple and equitable alternative that will remove the current tax impediment to the operation of an efficient market for the sale of businesses or business assets. The Government has expressed an intention to introduce the changes this year.

5. Taxation Considerations for the Vendor in Selling Business Assets

(i) Apportionment of the Sale Price

It is important to structure the sale of business agreement with an apportionment of the sale price to the actual assets transferred. Namely, it is not only desirable to have an identification of the actual assets being conveyed but also it is important to have an appropriation of value to each of the assets.

There are various provisions in the tax legislation which allow the Commissioner to make his own appropriation of value. However, as a matter of general practice, the Commissioner will accept the values selected in the contract where the parties are at arm's length.

(ii) Land and Buildings

As discussed earlier in the paper, certain pre-CGT assets may be deemed to be post-CGT assets if owned by a company where the ownership of that company has altered significantly – see subdivision 149-B of the ITAA 1997.

Assets acquired after 19 September 1985 ("post-CGT") will be exposed to capital gains tax. A liability to CGT will arise where the consideration for the land exceeds the so-called "cost base" of that asset. The cost base will, in general terms, include the original cost, plus purchase costs (such as stamp duty and legals).

Note that the date for purchase and acquisition for CGT purposes is the date of entry into the contract (not necessarily settlement) (section 104-10(3) of the ITAA 1997).
Buildings on land are treated as separate assets for tax purposes where the land is a pre-CGT asset

and the building was constructed post-CGT (section 108-55 of the ITAA 1997). Accordingly, in this situation, a separate value for the building should be selected in the contract.

If there is to be a CGT liability on the sale of the land and buildings then the taxpayer will need to determine if the CGT concessions are available to reduce the rate of tax payable.

Different deduction rates for "depreciation" of buildings apply (i.e. either 2.5% or 4% p.a.) depending upon the date of commencement of construction and the type of structure under Division 43 of the ITAA 1997. The amount of depreciation will be "claimed back" on disposal of the building after 30 June 2001. However, for buildings commenced to be constructed after 13 May 1997, the building allowance ("depreciation") will give rise to a tax liability if the sale proceeds exceed the "termination value" of the building.

(iii) **Plant and Equipment**

Any amount received by the vendor in excess of the tax written down value of plant and equipment (original cost reduced by the amount of depreciation claimed as a tax deduction) will be subject to tax as ordinary income. Note that depreciable items (plant and equipment) are excluded from the CGT provisions and as a consequence any amount in excess of the written down value cannot be reduced under the small business CGT concessions.

Generally, the vendor would be best advised to apportion a value to plant and equipment equal to the tax written down value or less. In the situation where the vendor receives less than written down value for plant then the vendor is entitled to a tax deduction equal to the shortfall. The deduction is on revenue account.

(iv) **Leased Premises**

Normally no tax consequences arise where the business premises are leased. In this case, either the vendor under the sale contract will assign the lease or, alternatively, the purchaser and the landlord will enter into a new lease separate from the contract of sale.

(v) **Plant and Equipment Leases**

Any premium received by the vendor for the assignment of equipment leases (e.g. where the market value of the equipment exceeds the residual value) will be subject to tax in the hands of the vendor as ordinary income.

(vi) **Trading Stock**

Where the consideration received is less than the original cost of the trading stock then the vendor may claim the shortfall as a deduction on revenue account.

A deferral of tax liability on trading stock can be achieved by excluding the stock from the sale contract and providing for the stock to be taken by the purchaser on consignment.
The Commissioner of Taxation has the power to apply "market value" on the sale of stock (section 70-90 of the ITAA 1997). However, where the parties are at arm's length, the price selected in the contract is, as a matter of practice, accepted. As with plant and equipment, trading stock is excluded from the CGT provisions and as a consequence any amount in excess of the book value cannot be reduced under the small business CGT concessions.

(vii) **Debtors**

In the event that debtors are included in the sale contract (which is not normally the case – see below) then the consideration received by the vendor will not generally be subject to tax. Namely, most businesses return their income on an earnings (accruals) basis and, therefore, the vendor will have already brought the invoices to account for tax purposes as income. However, if the vendor is a cash basis taxpayer, then the consideration received for debtors transferred in the sale contract will be subject to tax as ordinary income. Any debts written-off prior to the sale (and not transferred) will be tax deductible to vendors on revenue account.

A purchaser will generally not acquire debtors in a business sale contract as the purchaser will not have the ability to claim as a tax deduction any debtors being written off as bad, subsequent to the sale contract. Normally, the purchaser will enter into an agreement to collect the debtors for the vendor on an agreed collection/administration fee basis.

(viii) **Goodwill**

The tax treatment of the sale of goodwill was considered by the High Court in *FC of T v Murry* 98 ATC 4584. The tax concept of goodwill (based on the legal concept) is limited to the extent to which a business owner has the right to defend the business from unlawful competition. In this way, little or no goodwill value (whether called "goodwill" or not in the contract) will be recognised for tax purposes in, for example, the following circumstances where:

(a) the business is not conducted by the vendor but rather leases the right to carry on the business to another;
(b) the business does not have a recognised customer basis, for example, businesses which do not rely on repeat trade such as taxis;
(c) the right to carry on the business depends upon a licence of some kind (unless the licence is an exclusive licence);
(d) the business is a one person professional practice or trade.

The importance of "goodwill" from a tax viewpoint in a contract of sale of business is two-fold:

(a) where the business is a so-called "pre-CGT business" then any consideration for goodwill will be exempt from tax; and

(b) where the business is a so-called "post-CGT business" then any consideration for goodwill could be reduced by the capital gains tax concessions discussed above.

The decision in *Murry* limits the amount of value that can be attributed to goodwill for CGT purposes. Accordingly, the ability of a vendor to reduce the CGT exposure by allocating value to goodwill on the sale of a business may not be as great an opportunity as was previously thought prior to *Murry*.

Other implications of *Murry* that could apply to vendors are:

(a) Goodwill is inseparable from the conduct of a business – goodwill does not inhere in the identifiable assets of a business. Accordingly, the sale of a particular asset of a business (separate from the business itself) does not involve any disposition of the goodwill of the business. That is, a partial sale of a business does not involve any goodwill (unless that part sold can stand alone as a separate business;

(b) The goodwill of a business may change in its nature if the business changes. That is, to retain a so-called pre-CGT nature of goodwill in a business it may be necessary that the business must comply with some form of "same business" test.

(ix) Licences/Franchise Rights

The High Court in *Murry* held that licences do not attract custom (the source of goodwill) but rather authorises the conduct of activities which may attract custom. Accordingly, where the vendor is disposing of a business which includes a licence (statutory or otherwise) or some franchise, then a value for tax purposes will be attributed to that licence or franchise, as the case may be, separate to goodwill.

If the licence has a separate market value (such as water licences, liquor licences, abalone fishing licences, and the like), then the sale contract will need to apportion the price to such an asset as consideration for the transfer of the licence (and not goodwill).

Where the licence is a post-CGT asset then the consideration will be subject to capital gains tax. Where the licence is an exclusive licence then it may be possible to apportion some of the value of the licence as goodwill. In this case, the exclusive nature of the licence may be seen to enhance the value of goodwill but also may be itself a source of custom in respect of the

(x) Restrictive Covenants

A restrictive covenant is regarded as a separate asset for tax purposes. Any consideration allocated to a restrictive covenant in the sale contract will be subject to capital gains tax. This will be the case whether the business is a so-called pre-CGT business or not.

In *Murry*, the High Court appeared to accept that a restrictive covenant given by the vendor not to compete with the purchaser is similar to an exclusive licence. Namely, the covenant enhances the value of the goodwill of the business and in that sense is taken to be part of the goodwill.

For this reason it is recommended, from a vendor's tax point of view, not to appropriate a value for a covenant where there is an advantage to be gained for maximising the value of goodwill in the contract of sale. The restrictive covenant can never qualify for the Division 115 discount as it is expressly excluded: section 115-25.

In Taxation Ruling TR95/3, the Commissioner states that he will generally accept the values selected by arm's length parties in respect of goodwill and restrictive covenants. However, the ruling goes on to state that the Commissioner will determine a reasonable attribution of value to a restrictive covenant if the parties have not otherwise made such an attribution.

(xi) **Work in Progress**

If the contract for sale of the business includes an amount for work in progress, this will be treated as assessable income of the vendor (*Crommelin v FC of T* (1998) 39 ATR 377).

Prior to *Crommelin*, the Commissioner, as a matter of practice (see IT2551 – now withdrawn), accepted that a vendor would not normally be assessed on amounts representing work in progress. Usually taxpayers would allocate a larger amount to "goodwill". This approach was adopted by the Commissioner as the purchaser would also be assessable on the work in progress, resulting in double taxation.

Following *Crommelin*, the law was amended such that the vendor is assessable on any amount representing work in progress but that the purchaser will be entitled to a deduction for the amount paid to acquire the work in progress.

(xii) **Prepayments**

Reimbursement by the purchaser of prepayments made by the vendor will be assessable income of the vendor if the vendor has claimed the prepayment as a tax deduction. Otherwise, the reimbursement would be tax neutral.

(xiii) **Employee Entitlements**

Where the purchaser assumes the liabilities of the vendor for annual and long service leave of employees, then the vendor is not allowed a deduction for tax purposes of the amount of the liability assumed by the purchaser. Instead, the assumption of the liability has the effect of reducing the sale price and this reduction is of a capital nature.

As the purchaser will ultimately earn a tax benefit from assuming the liability, then it is usual in sale contracts to value the assumed liability at less than its face value. For example, an after tax position relating to the purchaser would mean that only 70c in the dollar of the face value of the assumed liability is allowed by the vendor. This is based on a company tax rate of 30c for the purchaser.

Alternatively, the vendor could simply pay out the accrued annual and perhaps the long service leave entitlements to the employees. This would entitle the vendor to a tax deduction for the amount paid.

(xiv) **Intellectual Property**

Where the vendor is the owner or licensee of an Australian patent, registered design, or copyright, then the vendor may have claimed tax deductions in respect of the cost of such assets (pursuant to Division 40 of the ITAA 1997).

In this event, any consideration on disposal of these assets will be subject to tax to the extent that the consideration received exceeds (but not greater than the original cost) the tax written down value of the asset (the so-called "residual value"). The application of capital gains tax is expressly excluded: section 118-24.

Note that the High Court decision in *Murry* confirms that there is no goodwill component in the value of, say, patents or copyright. Accordingly, the vendor will benefit by apportioning a value to industrial property items equal to the tax written down value, leaving any balance to be classified as goodwill or some other active asset that is subject to the operation of the CGT provisions. However, against this the purchaser will argue for a high price (as a tax deduction can be claimed pursuant to Division 40 of the ITAA 1997).

(xv) **Post Sale Costs**

Where the vendor has sold the business but the proceeds are insufficient to meet debt obligations of the previous business, then the vendor will be entitled to continue to claim the funding costs as a tax deduction (*FCT v Brown* (1999) 99 ATC 600). This is despite the fact that there is now no longer any business activity associated with the loan obligations. The deduction may still be allowable even after the loan has been refinanced (*FCT v Jones* [2002] FCA 204).

In the event that the vendor has to meet warranty or indemnity claims in respect of warranties and indemnities provided by the vendor in the sale of business contract, then such amounts are treated as a reduction of the sales price. The vendor would need to treat such claims by seeking an amended assessment to include the cost of the warranty/indemnity as a reduction in the value of the sale consideration.

6. Taxation Considerations for the Purchaser

(i) Apportionment of the Purchase Price

The importance of apportionment of the purchase price for the purchaser is a question of the cost of funding. If the purchaser can obtain an immediate tax deduction for part of the purchase price of the new business then the cost to the purchaser of that business is reduced. This generally results in the purchaser seeking to maximise the value of stock and plant and minimise the value of goodwill. This position is in direct conflict with the vendor.

If the contract apportions the price then the parties will have come to an agreement about apportionment as part of the commercial negotiations. The tax position of each of the vendor and the purchaser can be calculated with some certainty.

(ii) Land and Buildings

As land is an asset that is likely to be held for some time then any part of the purchase price apportioned to such assets will not be “deductible” to the purchaser until the time of disposal of the land.

Whatever the consideration apportioned to buildings this will not have any impact on the amount entitled to be claimed as a tax deduction under Division 43 of the ITAA 1997. Namely, the allowance previously claimed by the vendor is inherited by the purchaser without alteration. Any repairs that are needed to be carried out immediately by the purchaser on buildings acquired should be covered in the contract. Namely, the purchaser may be denied a tax deduction for such repairs and, therefore, it would be preferable to require the vendor to undertake the repairs prior to sale with an appropriate allowance in the contract. It will usually be the case that the vendor will have a greater chance of successfully arguing that the expenses are deductible and are not of a capital nature. Even if the expenditure is of a capital nature to the vendor a deduction of sorts is immediately available as the cost will reduce any gain made on the sale of the land. The contract adjustment would recognise the after tax cost of the repair to the vendor.

(iii) Plant and Equipment

The purchaser will favour the highest price apportionment to plant and equipment that can be justified (this is contrary to what the vendor will generally wish); the reason being that the purchaser is entitled to claim depreciation and, accordingly, obtains a tax deduction for the capital cost.

Items of plant and equipment to be acquired should be carefully considered by the purchaser. If items are to be scrapped on the purchase then this should be undertaken by the vendor and a price adjustment (on an after tax basis) be made. Alternatively, the purchaser should ensure that the item of plant is initially used in the purchaser's business and then scrapped. Otherwise, the cost write-off on the scrapping of the plant is not tax deductible to the purchaser. Repairs should be treated in the same manner as discussed under "Land and Buildings".

(iv) **Lease Premiums**

Any premium paid for the grant of the lease will be treated as capital and non-tax deductible. In this case, on the termination of the lease, the purchaser will be entitled to a capital loss (tax deductible against capital gains).

(v) **Plant and Equipment Leases**

Any premium paid by the purchaser to compensate the vendor for the difference between the market value and the residual value of plant under lease should be able to be claimed as a tax deduction (on revenue account) by the purchaser.

(vi) **Trading stock**

The purchaser is better off (generally) in apportioning the highest justifiable value to trading stock (this is contrary to what the vendor will generally wish). There will be an immediate deduction on the sale of the stock. Obsolete stock should not be acquired by the purchaser for a value in excess of market value, as that value will be reduced to market value on acquisition and no deduction will be allowed.

(vii) **Debtors**

The purchaser is unable to claim a deduction for any bad debts assumed from the vendor under section 25-35 of the ITAA 1997. Usually the purchaser will collect the debts on behalf of the vendor for a commission, and the commission will be assessable income of the purchaser.

(viii) **Work in Progress**

The purchaser is entitled to a deduction for the amount paid to acquire the work in progress. (Section 25-95 of the ITAA 1997). When the work in progress is actually billed and recovered the purchaser would be assessable on it at that time.

(ix) Prepayments

Where the vendor has prepaid expenses relating to the period after completion for which it has claimed a tax deduction, then it is normal for an adjustment to be made to the purchase price. The purchaser will pay the after tax cost to the vendor of the expense. The payment by the purchaser will be of a capital nature and not deductible.

(x) Annual and Long Service Leave

The purchaser should ensure that the long service leave provision is calculated properly as the business may not recognise this liability. The purchaser will not be assessed on any amount allowed to the purchaser for annual or long service leave liabilities. The purchaser can claim a deduction at the time the leave is paid to the employee.

For these reasons, where employees are retained in the business, an allowance is made in favour of the purchaser in respect of long service leave and annual entitlements. In taking on the staff, the purchaser will become liable for these payments, thus an allowance is required. The adjustment is usually made to the date of settlement and the purchaser should then indemnify the vendor for any claims arising after settlement.

Another alternative, in respect of annual leave, is to have the vendors pay out the employees and the purchaser to re-employ any employees in the new entity.

(xi) Warranties and Indemnities

If a purchaser is compensated for having paid excessive consideration to acquire an asset, this represents a recoupment of all or part of the original acquisition cost of the asset under section 110-25 of the ITAA 1997 (TR 95/35).