CA TAX DISCUSSION GROUP NO. 2 – MAY 2017

BEN SYMONS

BARRISTER – STATE CHAMBERS

Buy-sell agreements

- Essentially an agreement for the transfer of an equity interest in a business upon the death of a co-owner;
- 2 major types of agreements:
  (a) Mandatory agreements – a deceased party/estate must sell, remaining parties are obliged to buy; and
  (b) Put and call options – deceased party/estate has the option to sell, remaining parties have the option to buy.

Mandatory agreements - Tax issues

- When does the contract to sell form? Is there a condition precedent or a condition subsequent
  (a) Condition precedent – contract forms when condition is fulfilled (possibly many years later); and
  (b) Condition subsequent – contract forms on initial entry in to agreement:
    - Likely nil capital gain, because asset purchased and sold simultaneously; and
    - 12 month CGT discount not available because asset owned less than 12 months.

Buy-sell agreements – call/put options

- The exercise of an option will usually be a condition precedent to the formation of a contract for sale;

Put and call options - Tax issues

- The granting of an option triggers CGT event D2; a capital gain arises in the amount of the capital proceeds for the seller; and
- However, this CGT event is disregarded if the option purchaser exercises their option:
  - (i) CGT event A1 will be triggered at the time that the option is exercised;
  - (ii) Capital proceeds if CGT event D2 disregarded?
  - (iii) The 12 month CGT discount will be available if greater than 12 month has passed since the option was issued.

Buy-sell agreements - funding

- Buy-sell agreements are typically funded by life insurance policies that pay out in the event of death of TPD;
- There are 3 main types of policies; and
- Self ownership:

  (i) Self-ownership;

  (ii) Cross-ownership; and

  (iii) Policy taken out by company or trust.

Buy-sell arrangements - funding

- Self ownership:

  (i) Policy pays out to estate of individual (or individual if TPD) – represents proceeds of sale of business – proceeds exempt under s118-300 ITAA 1997 (or S 118-37 if TPD); and

  (ii) Remaining principals acquire deceased interest in business for no consideration – hopefully obtain market value deeming s 112-20 ITAA 1997.

- Cross ownership:

  (i) The proceeds of life insurance policy pay out to remaining principals – can be used by them to acquire deceased interest;

  (ii) Key issue – if pay out to original policy holder / principal definitely exempt under s 118-300 ITAA 1997;

  (iii) If pays out to subsequent policy holder /principal – only exempt if they paid to consideration to acquire interest in policy (unlikely); and

  (iv) Also difficult to protect interests of beneficiaries in a cross ownership situation.

Buy-sell arrangements funding

- Company / Insurance trust takes out policy:
  - (i) Policy pays out to company or insurance trust;
  - (ii) Has the **advantage that the company / trust is the original policy holder and can therefore always get the benefit of exemption under s118-300 ITAA 1997**;
- Company – taxation treatment – buyback of shares will be part capital and part franked dividend for deceased estate;
- Trust distribution can be distributed to beneficiaries – must be sure to draft class of beneficiaries widely in trust deed to ensure that new owners don't trigger a resettlement of trust; and
- Note that companies and trusts cannot get the benefit of exemption on the payout of a TPD policy because s118-37 ITAA 1997 only applies to natural persons.

Business conducted out of a company - share sale v asset sale

- If the business is conducted out of a company, a seller will generally prefer a share sale to an asset sale;
- **Advantages to the seller of a share sale:**
  - (i) access to small business CGT concessions (if the 20% holding requirement is satisfied);
  - (ii) Likely lower stamp duty on sale of shares (purchaser issue) – see below;
  - (iii) Buyer may get access to losses in company; and
  - (iv) Less effort / legal hurdles / documentation to transfer employees and assets (particularly IP);
- Legal advantages: company has separate legal personality; any on-going legal and tax issues are issues for the company rather than the seller as an individual; and
- If undertake an asset sale from company, pay up franked dividends (effectively the seller receives dividend income, no ability to use capital gains tax concessions)

Purchase price allocation

- Purchase price must be allocated between different assets based on parties "dealing at arm's length" (not a specific legislative requirement, but see Collis v FCT 96 ATC 4831);
- Generally, the nature of the assets and the bargaining process will lead to an allocation where the parties "deal at arm's length";
- Assets should be identified as separate assets to the extent possible under accounting standards in the sale and purchase agreement for tax purposes (TR 1999/16) and restrictive covenants should be separately identified as well:
  - (i) Intellectual property should be identified as separate assets to the extent possible under accounting standards (e.g. know-how, scientific knowledge, customers lists etc); and
  - (ii) Restrictive covenants must be separately identified; and
- Little goodwill attaches to the sale of a solo professional practices (TR 1999/16 para 59 and High Court case of FCT v Murry 98 ATC 4585).

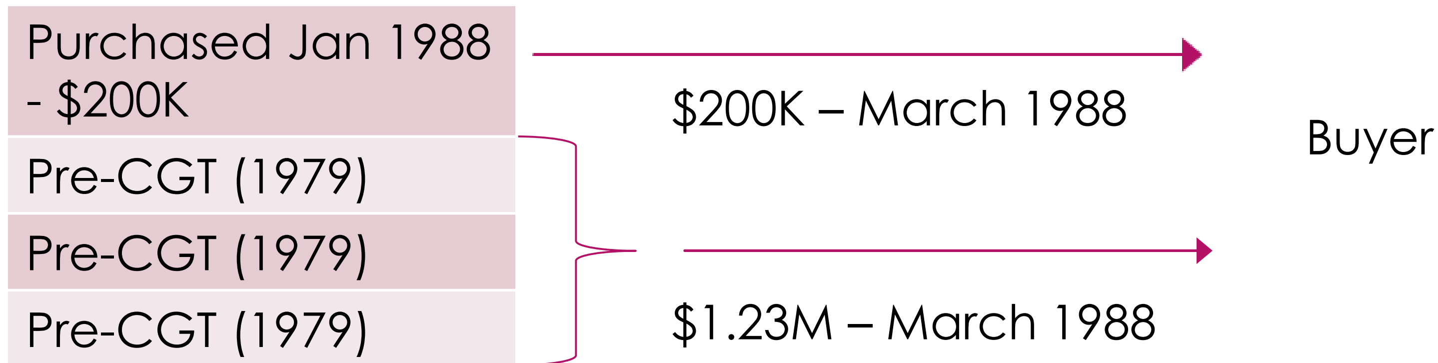
Purchase price allocation

- Seller generally prefers a higher price to be allocated to capital assets – buyer can obtain CGT concessions on sale of these assets;
- Buyer generally prefers a higher price be allocated to depreciating assets because it can depreciate them and claim a deduction sooner;
- Buyer and seller generally both prefer a lower value for inventory (careful to ensure an arm's length price – see Collis v FCT 96 ATC 4831); and
- But note, a higher value for certain assets means a higher stamp duty charge in NSW:
  - (i) Land
  - (ii) Goodwill;
  - (iii) Intellectual property;
  - (iv) Statutory licenses; and
  - (v) Unlisted shares.

Purchase price allocation

Asset type	Seller generally prefers
Goodwill	Higher price allocation
Restrictive covenant	Higher price allocation
Land	Higher price allocation
Other capital assets (eg know how)	Higher price allocation
Inventory / stock on hand	Lower price allocation
Motor vehicles	Lower price allocation
Depreciating assets (plant and equipment)	Lower price allocation
Intellectual property	Lower price allocation

Purchase price allocation – Collis v FCT 96 ATC 4831



- The taxpayer had acquired 3 abutting parcels in 1979 (pre-CGT). The 4th parcel was acquired for $200,000 in January 1988;
- The taxpayer sold 4 parcels of land to a buyer in March 1988. The sale price was $1.43 million and determined in an auction;
- The taxpayer sold them in two contracts – the taxpayer assigned $200,000 to the most recently purchased parcel resulting in no gain, and the balance to the pre-CGT parcels;
- The Commissioner successfully reassessed the taxpayer apportioning value to the parcels based on land area (this gave the 4th parcel purchased in January 1988 a value of around $350,000)

Stamp duty - rates

Value of the property subject to the transaction	Rate of duty
$0 - $14,000	$1.25 for every $100 or part of the value
$14,001 - $30,000	$175 plus $1.50 for every $100, that the value exceeds $14,000
$30,001 - $80,000	$415 plus $1.75 for every $100, that the value exceeds $30,000
$80,001 - $300,000	$1,290 plus $3.50 for every $100, that the value exceeds $80,000
$300,001 - $1m	$8,990 plus $4.50 for every $100, that the value exceeds $300,000
over $1m	$40,490 plus $5.50 for every $100, that the value exceeds $1,000,000
Premium Property Duty: over $3m	$150,490 plus $7.00 for every $100, that the value exceeds $3,000,000.
Unlisted share prior to 1 July 2016	60c per $100

Stamp duty – traps for the unwary

- The buyer generally has the obligation to pay stamp duty (they must pay within 3 months of transfer);
- Transfer of an interest in land (freehold or leasehold) and goods (fixed plant but not stock in trade) are subject to stamp duty in NSW;
- Where only dutiable property is goods, this should be excluded from duty under s26 *Duties Act 1997* (NSW);
- As of 1 July 2016 business assets being goodwill, intellectual property and statutory licenses and mortgages and unlisted shares are not subject to stamp duty;
- Important to keep stamp duty in mind in relation to the implications of the allocation of the purchase price to different assets;
- Stamp duty is payable on the GST inclusive price;
- Assets liable for stamp duty identified above where they relate to a business conducted in NSW in the previous 12 months; and
- No advantage anymore in relation to a share sale over an asset sale.

Goods and services tax – sale of a "going concern" GST Free

- Ideally the sale should be structured so it is the sale of a "going concern" and will be GST free pursuant to section 38-325 of the GST Act;
- To qualify for this exemption:
  - (i) The sale must be for consideration (it almost always will be);
  - (ii) Both the buyer and seller must be registered for GST;
  - (iii) The seller must sell ***all things necessary*** for the continued operation of the business;
  - (iv) The buyer and seller must agree in writing that the sale of the business is the supply of a going concern (and ideally mention section 38-325 of the GST Act); and
  - (v) The seller must carry on the business up until settlement date.

GST – sale of a going concern – practical issues

- Where assets have to be transferred from different entities, this may be risky;
- ATO takes the view that all assets should be sold to a single person/entity for the going concern exemption to apply (GSTR 2002/5);
- Risky to exclude an asset as being part of the sale;
- All licenses necessary for conduct of business should be transferred (or seller should otherwise facilitate their acquisition by buyer);
- Any property / leased premises should be transferred; and
- If the exemption does not apply, the seller charges GST, the buyer can claims input tax credits (just a cash flow problem for the buyer).

Warranties

- Consider buyers objects in obtaining warranty:
  - (i) Sharing of risk;
  - (ii) Protection going forward; and
  - (iii) Obtaining information and negotiating the purchase price.
- A seller generally prefers a more limited warranty;
- Commercial considerations often dictate that the seller should be open with the buyer; and
- May adjust purchase price to reflect defects / uncertainties.

Tax issues – traps for the unwary - adjustment of purchase price

- It may be important to adjust the purchase price depending on who bears certain tax liabilities;
- Land tax – keep in mind that it is the owner of land on 31 December that is liable for land tax in the following year;
- Seller on a cash basis – payment for debtors is assessable income; likely not deductible for purchaser (may ask for an adjustment in purchase price);
- Seller on accruals basis – neither seller or buyer will be able to claim a deduction for a bad debt; and
- Work in progress is deductible to acquirer (s 25-95 ITAA 1997) but may be capital where cannot be identified in payment made to outgoing partner.

Small business CGT concessions

- The 50% automatic CGT exemption applies for individuals and trusts (s 115-100 of the 1997 Act);
- There are a number of other small business CGT concessions that may apply to gains on capital account:

  (i) 15 year exemption;

  (ii) active asset exemption;

  (iii) small business retirement exemption; and

  (iv) small business asset rollover in to a new business.

Small business CGT concessions – basic conditions

- The taxpayer must satisfy ***one of the basic conditions below*** to qualify for one of these CGT concessions are (Section 152-10 of the 1997 Act):

  (i) the entity realising the gain is a "small business entity" – i.e. It has turnover of $2 million or less;

  (ii) the taxpayer has net assets of less than $6 million (also count entities and affiliates that the taxpayer controls);

  (iii) the taxpayer is a partner in a partnership that has turnover of less than $2 million and the asset is an asset of the partnership;

  (iv) the taxpayer does not carry on business, but an entity that it controls does and is a small business entity and the asset on which the gain is realised is used in that entity's business;

  (v) the taxpayer is a partner in a partnership that has a turnover of less than $2 million and the asset on which the gain is realised is a personal asset of the taxpayer's used in the partnership; and

- The CGT asset must also satisfy the 'active asset' test.

Small business CGT concessions – ‘active asset’ exemption

- An asset held by an individual is an active asset where:
  - (i) If it was held for less than 15 years before the CGT event, it was used in a business for at least half the time it was owned;
  - (ii) If it was owned for more than 15 years before the CGT event it was used in the business for at least 7 ½ years.
- An asset held by a company or a trust is an active asset if:

  (i) The value of the market values of the assets that the company or trust uses in its business constitute at least 80% of the market value of the company or trust.

Small business CGT concessions – basic conditions

- Additional conditions must be satisfied for an interest in a company or trust;
- Either:

  (i) an individual must have an interest (directly or indirectly) of at least 20% in the company or trust (i.e. rights to income/capital/voting rights); or

  (ii) where that individual's spouse has an interest greater than 0, and the individual and their spouse together have 90% of the voting/capital/income rights in that company/trust.

Small business CGT concessions – 15 year exemption

- The 15 year exemption allows a capital gain to be disregarded completely;
- The basic conditions in section 152-10 of the 1997 Act are satisfied;
- The taxpayer continuously owned the asset for 15 years up to the time of the CGT event;
- The individual receiving the gain must either be over 55 or permanently incapacitated;
- If the gain is realised by a company or trust, they must have stakeholders with 20% or greater entitlement to income/capital/voting rights for at least 15 years (does not have to be continuous and does not have to be the same individual); and
- This exemption takes precedence over all other exemptions.

Small business concessions – 50% reduction

- If the basic conditions in section 152-10 of the 1997 Act are satisfied, the taxpayer is entitled to a 50% reduction on the capital gain; and
- This concession can be used in conjunction with:
  - (i) The small business retirement exemption; and
  - (ii) The small business rollover.

Small business concessions – retirement exemption

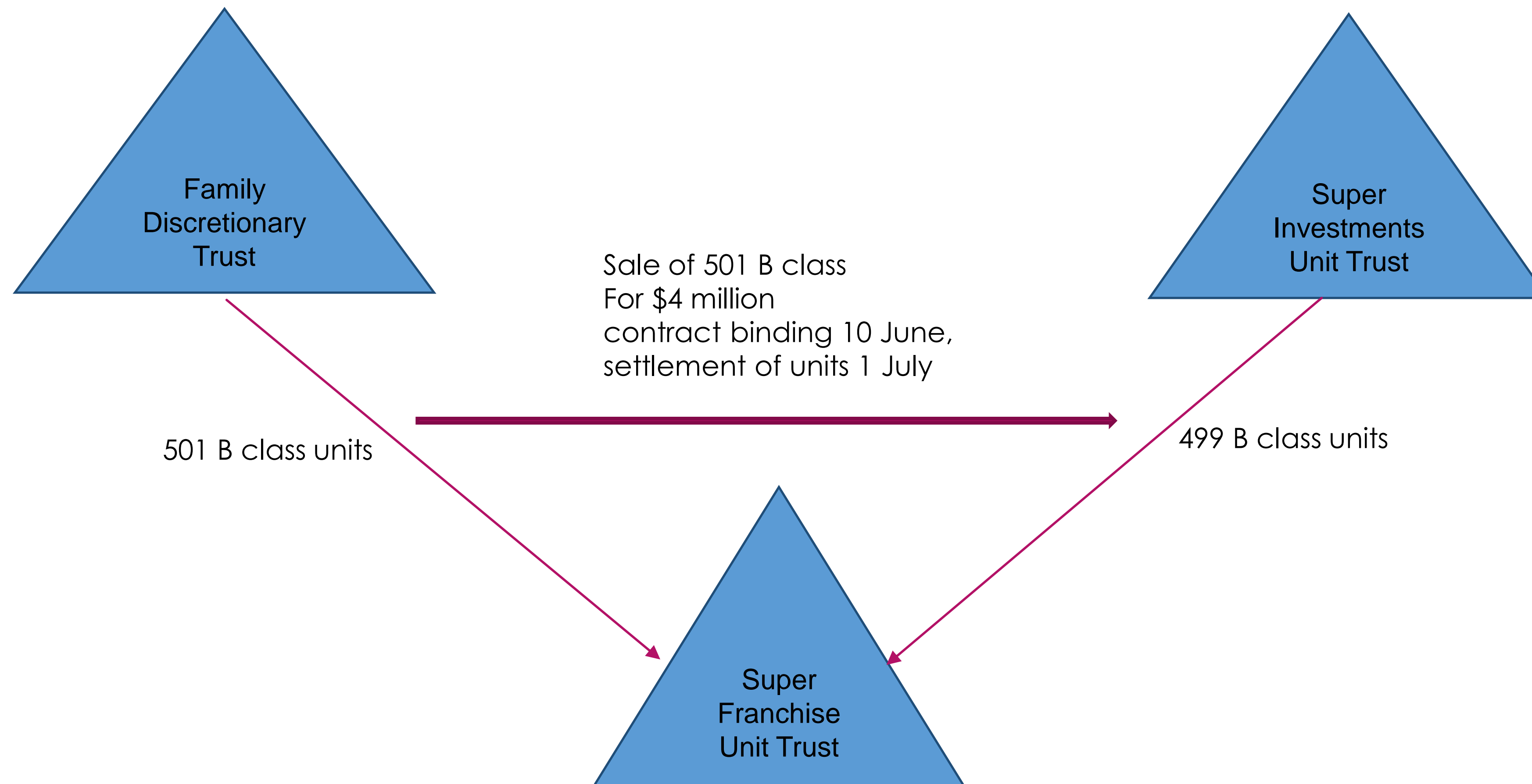
- Allows the capital gain to be treated as exempt up to a lifetime limit of $500,000 (must take in to account previous exemptions claimed);
- The basic conditions in section 152-10 of the 1997 Act must be satisfied;
- If an individual receives a capital gain and they are under 55 , they must elect in writing to contribute the gain to a complying superannuation fund; and
- If the capital gain is being paid through a company or trust:

  (i) it must be paid to a CGT concession stakeholder (i.e. Someone with 20% of voting/income/capital rights or their spouse);

  (ii) It must be paid within 7 days of the later of when the company or fund made the choice or when payment of the capital gain was actually made;

  (be mindful of whether 90% of capital gain needs to be paid to CGT concessions holders).

Example: small business concessions



Example: small business concessions

Item	Amount
Total capital proceeds	$4,000,000.00
Less: cost base (could not deduct – not paid for by trust, paid by individual)	
Total capital gain	$4,000,000.00
50% automatic capital gains tax discount for your family trust	$2,000,000.00
50% 'active asset' exemption for your family trust	$1,000,000.00
Amount of taxable capital gain streamed to you and your wife individually	$500,000.00
Amount of taxable capital gain that you and your wife individually should **contribute to your respective complying Australian superannuation funds**	$500,000.00
Total taxable net capital gain for you and your wife individually	Nil

Small business concessions: traps for the unwary

- Ensure that the gain is on capital account;
- Be careful to draft trust deed and trust resolution correctly to allow streaming of capital gain;
- Ensure that you apply capital gains discounts correctly – take half of half of a capital gain;
- If selling to asset to another trust, does CGT event A1 or CGT event C2 apply? (affects timing of event – crucial if events in a different income year)
- Valuation: absolutely crucial – must include entire assets of trust if you own greater than 40% of the units in the trust;
- Valuations: consider the case of *Miley v FCT*?
- Valuation: can you deduct unpaid present entitlements? (see TR 2015/4)

Small business concessions – new business rollover

- If the taxpayer satisfies the basic conditions in section 152-10 of the 1997 Act, they can elect to rollover the gain in to a new business if they acquire replacement assets;
- Replacement assets usually consist of depreciating assets or licenses;
- To the extent that replacement assets are acquired within 2 years of CGT event, the gain or loss is disregarded to the extent of the cost of the replacement asset (there is a gain to the extent that replacement assets not acquired); and
- If replacement asset ceases to be used in the new business 2 years or later after original CGT event, CGT event J2 might arise.

Earn-out arrangements

- New legislation passed in February 2016 in relation to "earn-out" arrangements;
- Applies to earnout arrangements created on or after 23 April 2015;
- New section 118-565 defines a "look-through earnout right" to be a ***right to future financial benefits*** that meets the following conditions:

  (i)It is created under an arrangement that involves the disposal of a CGT asset (and specifically CGT event A1);

  (ii) The financial benefits are contingent on the economic performance of the CGT asset or the business of which the CGT asset is an active asset;

  (iii) The value of the financial benefits is contingent on economic performance;

  (iv) Just before the CGT event, the CGT asset that was the subject of the arrangement was an "active asset';

  (v) All of the financial benefits to be provided under the arrangements must be provided within 5 years of the end of the income year in which the CGT event occurred; and

  (vi) The parties to the arrangement deal with each other at arm's length.

Earnout arrangements – points of interest

- EM at para 1.27 states that the new legislation allows for deferral of payments of income tax in relation to extra capital proceeds received;
- Extra 'active asset' test – as an alternative to valuing assets of the business, can pass this test where:
  - (i) 20% holding requirement satisfied by individual or an entity in the company or trust;
  - (ii) Assessable income of the company or trust was greater than nil; and
  - (iii) 80% of the assessable income of the company or trust was derived from carrying on a business and was not interest, rent, royalties or FX gains.
- Temporarily disregard a capital loss that could be reduced under an earnout arrangements (realise loss gradually as earnout payments are received);
- "Replacement asset' small business rollover modified so that a replacement asset can be acquired up to 6 months after the last earnout payment;
- Amendments made so that late payment interest will not be imposed provided income tax return in year of sale is amended by the date that income tax return in the year the earn-out payment was received was lodged; and
- Commissioner has up to 4 years after the end of the income year in which last earnout payment was made to amend an assessment relating to an earnout payment; and
- If the new legislation does not apply, then the only guidance on this issue is TR 2007/D10 which states that the earnout should be valued at the time of the CGT event – although further payments will generally be taxable to the extent they exceed the market value of that right.

Contact details

Ben Symons – Barrister-at-law

State Chambers

52 Martin Place

Sydney NSW 2000

Ph: 9223 1522

Email: bsymons@statechambers.net

LinkedIn: www.linkedin.com/in/ben-symons-barrister