# Sale of Business
# 14/11/2023

CCH Learning:

Hi, everyone. Welcome to today's webinar regarding Sale of Business. I'm Alison Wood from Wolters Kluwer's CCH Learning, and I'll be your moderator for today. Just a few quick pointers before we get started. If you're looking for the PowerPoint for today's session, it's just saved in the handout section of your GoTo Webinar panel. Any sound problems, you can toggle between audio and phone, and shortly after the session today, you will receive an email letting you know the eLearning recording is ready to be viewed. You can ask questions at any point during the session today. Simply type them in the Questions pane. I will collate these questions and ask them at the Q&A at the end of today's presentation.

CCH Learning also offers a subscription service, which many people have termed Netflix for Professionals. It provides members with access to our entire library of recordings, as well as live webinars for a very competitive flat fee. That's for over 500 hours of content. For CPD purposes, your viewing is also logged automatically.

Your presenter today is Corey Beat from Crowe Australasia, an affiliate of Findex. With over 20 years of accounting and taxation experience, Corey is passionate about understanding the needs of clients and solving their complex tax challenges, delivering complex taxation advice in an easy to understand way across a range of industries. Corey works with clients large and small and was recognised as a finalist of the Tax Institute's SME Tax Advisor of the Year category in 2018. So without any further ado, I will pass you over to Corey to commence today's presentation.

Corey Beat:

Thank you, Alison, and thank you, everyone, for joining us today. As Alison mentioned, today we're talking about Sale of Business, and we've split this topic over a number of sessions where we cover the two main alternatives for selling a business, being the sale of the entity versus the sale of the assets out of the entity.

So today, we're focusing on having a case study approach, so we'll have practical examples that we're going to talk through. We're going to look at pre and post-CGT status of business and assets, a sale of the business assets, apportioning the sale proceeds across the assets of the business, and a very small component today will be focused on accessing the CGT small business relief concessions. We will be doing a more comprehensive small business relief session in the new year. Today, we'll just focus on those matters relevant to our sale of business.

So what are the stages of the sale process? A typical sale process will go through three key stages, stage one being getting the business ready to go to the market, stage two is the actual process of going to the market and looking for buyers, and stage three is doing and completing the deal. Things that we would get involved in in stage one with our clients as advisors, some of the items that we would look at here as we would look at the business highlighting any problems potential buyers may find in that business and assist clients with fixing those problems and getting the business ready for sale. The idea there being that we're trying to maximise the price our client can get. We might advise them on pricing and fair market price for the business. We don't want to go too high or too low to the market, and if we go too high, we might scare people off.

We need to identify potential buyers, and that might be either locally, nationally, or even internationally. So it's looking at our product or our service and identifying who might be the best purchaser to target. Evaluating with our clients whether they should sell the assets of the business or the entity itself. It can also extend to preparing an anonymous fact sheet, which is the initial marketing document that we send to potential buyers to indicate whether they would be interested. There's a more detailed information memorandum for once you want to start receiving offers, and key for our clients is assessing the most appropriate deal structure to optimise the tax position and, in particular, optimising the net cash our clients end up with post-sale.

We'd recommend that you engage with your clients anywhere up to two to three years prior to sale. Quite often, clients will come to us when they've got the offer on the table, and by then, it's too late to put anything that might rectify business problems or structure problems before the sale. So if we get in touch with our clients, we keep in touch, we ask them questions, find out when they're looking at exiting. That can give us the time to obtain a valuation of the business from a qualified valuer to give us an understanding of the value of the business, prepare that business for sale, so update or enter into a business plan, look at ways that we can enhance the profitability of the business, and consider any tax planning or restructuring we need to do prior to sale. So for SME businesses, the structure of how we sell is going to be invariably driven by the taxation considerations, and as I mentioned, the net cash position of the vendor is crucial. It's not just the tax, it's the actual net cash position that the client will want to know where they stand.

Stage two in the process involves making confidential approaches to potential buyers, engaging interest for the business. If you do have an interested buyer, we can then issue an IM along with a confidentiality agreement and potentially any non-solicitation. That's probably a key one we've seen over time where buyers come in, we want to make sure that they're not just coming in to pinch staff or clients. We deal with any questions from the client or from the purchaser and request non-binding indicative offers. We can then analyse those offers and the terms and conditions and then review the taxation implications of those offers and advise our clients on those tax outcomes.

Stage three, we're actually doing the deal. We're collating information for the due diligence phase. Purchasers will generally want to ask questions around the business taxation and accounting. We want to be ready for that. We can assist our clients in managing the due diligence process and deal with questions from the purchaser's due diligence teams. And nowadays, clients will often be requested to set up secure electronic data rooms, particularly where you've got multiple bidders, to control the due diligence process. The benefits of an electronic data room extend to being able to track what information has been accessed and who has been accessing that.

Other assistance we can provide as advisors is ensuring that there's favourable terms in the agreement, particularly around price and payment terms in respect of any earn-outs post-sale. We can work with the client's legal advisors to ensure that any financial and commercial aspects of the deal are correctly reflected in the sale and purchase agreement and then negotiate the final sale price to maximise the transaction terms resulting in our clients receiving the best net cash position. Now, the nature and extent of any due diligence will generally be dictated by the size of the transaction. Obviously, the bigger the transaction, the bigger the entity, the more due diligence is going to be required.

We start today with our facts for our case study. So our case study will work its way through the points that we're talking to today, so we'll get the background out of the way early. So we have business company, Underground Cables Pty Ltd, operated and owned by husband and wife team, Jim and Helen. They're both directors, and they're equal shareholders in the company. The company was incorporated on 1 November 2003, and each of them received a share each, so they're equal owners. The business has grown substantially over time and now has annual turnover in excess of $5 million and employs over 20 staff. Important for when we get to our CGT small business relief, at no stage have Jim or Helen previously applied the small business retirement exemption.

Jim and Helen have been approached by a private equity group to purchase their underground cabling business as part of a tucking into a larger infrastructure services business. So that's the target, that's where we were trying to get our purchaser to buy from. The term sheet, we've been provided with a copy, the details of which stipulates for the purchase of the business, specifically plant and equipment, trade and stock, and goodwill, and the purchase price is going to be $3 million cash payable on settlement.

First thing we look at in respect the sale of business would be the CGT status of business assets. So understanding the CGT status of the business is critical to accurately determining the tax outcomes associated with the sale. If we've got pre-CGT assets, we know that they can be sold tax-free, whereas if we've got post-CGT assets, we know we're going to have to deal with the CGT rules and potentially look at concessions to get our tax bill down.

One thing to look out for with businesses, especially companies, is that the company may have been incorporated, say in this case 2003, but it may have been incorporated as a result of a rollover from a partnership or a sole trader. So in that case, the underlying business assets that are subject to CGT could still be pre-CGT assets. To do that, we would check whether a valid rollover election has been made in relation to that initial transfer of the business from the partnership or from the sole trader to a company. An invalid election potentially prejudices that goodwill or CGT assets, pre-CGT status, and it may be in those circumstances we need to go to the commissioner for a ruling. We know that these days, elections are in the most part evidenced by how we complete the return, but under the old '36 provisions, a lot of these elections needed to be made in writing, so it's critical to get that point right.

The other thing to watch out for is any changes in ownership of the company or unit trust where we're selling the underlying assets. So whilst the assets of the company may be pre-CGT, any changes in ownership could put that at risk. This happens under Division 149 of the '97 Act. So when we're selling pre-CGT assets, we need to check that DIV 149 has not been triggered, deeming our pre-CGT assets to become post. It applies where there's been a change of 50% or more the underlying interests in the pre-CGT assets, so we're looking at the shareholder level or the unit holder level.

As noted where DIV 149 is triggered, the underlying asset is deemed to have been acquired at market value at the time of that ownership change. So we might lose pre-CGT status, but we will still get at the very least a market value uplift. Obviously, the later that DIV 149 trigger occurs, hopefully the better that market value cost base is for our clients.

Just a quick example, a basic example to show how this works with a company with two pre-CGT shareholders, A and B, the company has pre-CGT assets. If B was to sell their shareholding to C, we've triggered a DIV 149 event. So we've had a change in underlying ownership of 50% or more, meaning the company's pre-CGT assets are deemed to have been acquired at the time we have the failure event, and we'll have a market value cost base going forward for CGT purposes. So critical to look through ownership of our companies and unit trusts when we are selling underlying assets, particularly if there's a pre-CGT component.

What are our options for selling the business? The two main alternatives we have for affecting a sale of a business will be a sale of the business assets by the holding entity, whether that's a company or a unit trust, or a sale of the entity itself, that is we either sell the shares in the company or the units in the trust. In all cases, it's critical to do a comparison for the client to determine whether it's preferable to sell the business or the entity, and the preferred option will often depend on the particular circumstances of the seller and the buyer. So while the seller may have a preference in selling either the entity or the assets, the buyer will have their own preference. They may not want to buy an entity, and there's commercial to and fro negotiations that'll need to happen to get both parties on the same page. Any advisors that fail to compare both options and model the outcomes can result in the client paying more tax than they need to overall. So again, critical that that comparison is done.

We've got a couple of very busy slides. I'm not going to go through these in detail. You've got the slides, but what we've got here are the advantages and disadvantages of a sale of business assets. We'll go through a few key points. Obviously for a purchaser, whatever the purchaser pays to acquire depreciating assets or trading stock, that becomes a deductible amount for them. They can get a deduction for trading stock for what they paid for it as they sell it and decline in value for the depreciating assets over time. For the purchase of the other benefit of buying the assets rather than the entity is that they don't inherit any previous liabilities of the entity. That stays with the purchaser who retains the entity. For the vendor, it can be easier to satisfy small business CGT concessions where you're only selling assets rather than the entity, and the sale contract can generally be simpler than any contract involving a sale of an entity.

However, on the disadvantages side, probably one of the key ones, particularly for the purchaser, is because they're buying the business assets and not the entity, they need to renegotiate all the supply and employment agreement contracts that will be coming with the assets. For the vendor, the problem will be that the sale proceeds will be locked in the entity, and we'll have to consider ways of getting those proceeds out in a tax-efficient manner. For the purchase, the other problem with the sale, of acquiring assets, I should say, is that there's often duty payable on the acquisition of assets under most state jurisdictions.

We flip that and look at the sale of an entity. A lot of these are really just mirrored for a purchaser. If they're already a consolidated group or they elect to consolidate, there's potential for them to still get an uplift in the tax value of assets, such as depreciation and trading stock. If they acquire as part of a consolidated group, if they are then concerned about historical liabilities once they've got the entity in their consolidated group, they can liquidate the entity, transfer all the assets to a existing group entity, and then liquidate the target.

There's no need to worry about assigning contracts or intellectual property. That all remains with the entity on sale, and there's often no stamp duty payable on the acquisition of shares or units, provided the entity isn't a landholder or land rich. Some disadvantages of an entity sale is that there's a reluctance, particularly in the SME market, to acquire entities because of the due diligence requirements. That's something that's not required if you're acquiring only assets, and existence of potential claims, whether that's taxation or any other liability, because you're buying the entity, you're buying that entity's history.

For the vendor, one of the disadvantages that it can be a little bit more difficult to obtain CGT small business relief, because you've then got to look at the additional entity requirements to be met in order to access. And legally, the sale contract will be a little bit more complex and lengthy than the contract for sale of assets. It needs to include warranties and things covering those historical matters that may pop up over time.

Now's a good time to stop for our first poll question of the day, and I'll hand back to Alison for that.

CCH Learning:

Thank you very much, Corey. Okay, everyone, we'll pop this first poll question up on the screen for you all, and I will run through the options for you now. So when preparing a business of sale, which of the following steps should be taken? So A, obtain a valuation, B, update the business plan, C, address existing problems, D, all of the above, or E, none of the above. Perfect.

So many people happily underway voting on this one. So if for the others who'd like to participate,, on the bottom of your toolbar you'll find a blue flower icon, and that will bring up GoTo Webinar in its entirety, and then you can click in one of the five radio buttons for this first poll question, and we've just got two polls in our session today.

All right, almost at majority. We'll just give those last people a couple of more seconds. And let's have a look at these results. So we had 92% with all of the above. Thanks, Corey.

Corey Beat:

Thanks, Alison. And yep, that would be the right answer. If we want to make sure that our clients get the best outcome, the best net cash position following sale, we'd want to get a valuation so that we're prepared, update the business plan, and make any changes we need to do to improve profitability and any existing problems that may be in the business or in the structure. So thank you for that.

Moving on, today we're going to focus solely on the commercial and a little bit of the tax considerations that we need to think about in a sale of business assets. So probably one of the first key issues is apportioning the sale proceeds. It's unlike where we sell an entity where we know that the sale price will be attributable to the shares or the units that we sell, if we're selling the business, we're usually selling a number of different categories of assets. And sometimes, a purchaser will be ambivalent as to what the purchase price gets agreed to. The parties simply agree to a sale price of X, and the parties to agree between themselves how that's allocated between the assets sold.

The commissioner will generally accept an allocation of proceeds as set out in the sale contract where that contract contains the detail, provided the parties are dealing at arm's length. As mentioned, some contracts don't allocate sale proceeds across assets, and the seller and buyer can then separately make a reasonable apportionment based on market value. The problem there, though, is if the commissioner was to review the transaction from both sides and see that both sides have come to wildly different apportionments, that may cause an issue for one or both parties going forward.

If the parties are not dealing in arm's length, the commissioner can use market value substitution rules to apply deemed market value to sale proceeds for depreciating assets for CGT and for trading stock. This apportionment and how the apportionment applies across assets can give rise to a conflict between the buyer and the seller. So if the buyer and seller can't agree, that's often where we see that there's no allocation of proceeds, and each party goes their own way.

The tension arises between the purchase and the seller, because the seller wants to maximise consideration that gets allocated to any pre-CGT assets, because they're tax-free, and obviously any CGT assets that'll qualify for concessional treatment, whether that's 50% discount or small business CGT concessions. On the purchaser's side, they get no benefit from amounts allocated to CGT assets, or at least no immediate benefit. What they want is that their consideration gets applied to trading stock or depreciable assets, because they get a more immediate tax benefit out of allocation to those categories.

What we often see is that the apportionment ends up being a compromise along the following lines. So trading stock will be at cost. Any work in progress, if there is any, gets transferred at calculated cost. Depreciable assets that they've written down value, intellectual property at written down value, any pre-CGT capital assets as much as we can justify, goodwill, the remaining amount, the excess and any assignments of leases or any business contracts get transferred at a nominal amount, unless for some reason they have specific value.

As noted, the ATO may challenge any apportionment across assets on the basis that they consider it to not be reasonable. Taxpayers who pluck a number out of the air in respect to their allocation should expect their allocation values to be challenged. So we would recommend sale proceeds are always allocated in the contract, even if it's in line with the previous slide, just valued at book value or at written down value. It's also important in circumstances where, say, we have pre-CGT land, but we've built post-CGT buildings on it. Consider whether we go into the minutia in the contract, obviously, if the purchaser agrees, and allocating proceeds across these pre and post-CGT assets to maximise any benefit we've got for the pre-CGT component of that land.

We now turn to goodwill. So there is a ruling, a tax ruling, that deals with the commission's approach to goodwill. It's 1999/16. The ATO note they'll accept an amount of vendor and purchaser allocate to goodwill provided all of the following requirements are met. So one being the parties are dealing at arm's length, and two being the parties do not allocate goodwill to goodwill an amount that should be attributable to an identifiable asset. So parties might say it's goodwill, but it's really attributable to work in progress or it could be trade names and logos or scientific, technical, industrial or commercial knowledge, which is dealt with under the royalty provisions.

The ruling commissioner notes he can treat parties as not dealing at arms length if one party is simply indifferent to the allocation of proceeds across the asset. So it's not just parties not dealing at arm's length and coming to a conclusion together. If one party is simply indifferent as to the allocation, the commissioner can use the not-dealing-at-arm's-length provisions there. So under tax law, as we've touched on, the disposal of assets will be dealt with as follows. So trade in stock sale proceeds are simply assessable income. Depreciating assets, we need to look at the balancing adjustment provisions in Division 40, and any other assets are effectively CGT events, and sale proceeds become capital proceeds in the calculation of the capital gain or loss.

So the ruling sets out the ATO on the treatment of goodwill based on the high court decision in Federal Commissioner of Taxation and Murry from 1998. So the ATO recognises that goodwill is a single CGT asset that is separate to the other business assets. Even though it's quite often linked, you can't almost have one without the other, they acknowledge that it is still a separate asset. The time of acquiring goodwill is taken to be the date of entering into the contract where we've purchased goodwill. So for example, if we've purchased a business and there is a goodwill component, that is the time that would been taken to acquire it. Quite often, though, a business will start from scratch, and goodwill will build up over time. So the commissioner accepts at the time of acquiring goodwill in those circumstances will be the time when the work commences that results in the creation of that goodwill.

Obviously, where we've commenced the business or acquired a business with goodwill prior to 20 September 1985, goodwill will be a pre-CGT asset, provided it is the same business that is being carried on. So that same business test for goodwill purposes requires that the essential character of the business remains unchanged. A mere expansion of the existing business will result in an expansion of an existing goodwill. However, if there is a business line that, if for whatever reason, no longer exists and the business has pivoted into other services or goods, that goodwill may not be available or may no longer exist.

So if we've got a goodwill asset that is a pre-CGT asset, and we sell that as part of a sale of business, there'll be no CGT payable. It's a pre-CGT gain and exempt from tax. For post-CGT goodwill, we may be able to get concessional CGT treatment. So if we're an individual or a trust selling our goodwill, we can get the general 50% CGT discount provided we've held that goodwill for greater than 12 months, and we could potentially be eligible to access small business CGT concessions.

Something that can pop up regularly with a sale of business is a restrictive covenant. So it sort of relates a little bit to goodwill, but it's a separate item. So a restrictive covenant is an agreement for the seller not to operate a similar business within an area or a region for a certain time period post-sale. If the vendor receives an amount to grant the restrictive covenant, that's capital in nature, not revenue.

So in the tax ruling 1999/16, the commissioner stipulates that a covenant is linked to the goodwill of a business, and if you do not allocate consideration to that restrictive covenant, the ATO will accept that there's been no capital proceeds attributable to it, and it all is attributable to goodwill. However, if proceeds are separately allocated, we have a CGT D1 Event occurring, being the creation of rights. That will result in a capital gain to the seller, as there will invariably be no or very little cost base for granting that right, other than maybe the legal fees that we've incurred to draught the agreement. And because the right only comes into existence when we create it, despite the fact that it might relate to a business that we've carried on for 20 years, the gain on that right is not

eligible for the 50% CGT general discount, because we've only created it at the time we enter into it. We're not able to satisfy that holding for greater than 12 month period.

Moving away from CGT, we now look at the depreciable assets and intellectual property. There's no CGT concessions available on disposing of depreciating assets and intellectual property items that are identified in Division 40 as depreciating assets. So the vendor will aim to allocate as little sale proceeds as possible to these depreciating assets, and the seller wants to minimise amounts allocated to IP to depreciating assets and maximise amounts allocated to goodwill. The purchaser will obviously be operating from the opposite perspective. They get a deduction for decline in value for depreciating assets and eligible IP assets, so they'll want to maximise proceeds allocated to that.

Interesting point to note. After the last couple of years where acquisitions of new assets have almost invariably been able to be deducted fully under the temporary full expensing and instant asset write-off rules, there may be a number of clients that have depreciating assets that have no tax written down value, or even their entire fixed asset register has been able to be written off under the small business pooling rules. So they'll have assets with a value maybe in the books or just an intrinsic value, but they'll have no tax written down value. And these assets, depending on what they are, they might be bigger items of equipment, yellow goods, bespoke equipment, bespoke plant, they may have significant value, and the purchaser may insist on allocating value in the contract to these items. For the seller, that will lead to an assessable balancing adjustment.

Now, we've not seen anything from the commissioner in this regard as to what he will and won't accept. I think there's an acknowledgement there that it really just comes down to that commercial tension between a vendor and purchaser as to what gets allocated to these particular assets that have been written off. But it's something to watch out for.

Trading stock. As the sale of a business is outside the ordinary course of a business, the act will deem a sale of trading stock in total to be a sale at market value on the day of sale and assessable income to the seller. A point to just draw out here is that the legislation talks about market value. It doesn't use, for these purposes, market selling value, which is one of your costs, your ways to value trading stock at year-end for tax purposes. So the difference between market value and market selling value is really important when you're selling outside the ordinary course of business.

So for a wholesaler, market value for their trading stock is likely to equate to its cost or the value you've got in your book. So a wholesale purchaser is not likely to want to acquire all of the trading stock of a business for its market selling value. So just one bit to watch out for there. You can sell trading stock in circumstances for its book value, provided that is equated to market value, and as I say, it's not market selling value we've got to look out for there.

Trade debts. Often in a sale of business, the vendor will generally retain any trade debts outstanding and recover them on their own. If the debts are transferred to the purchaser, the purchaser cannot actually claim a tax deduction on any debt that becomes bad, because the income has never been returned in the purchases taxable or accessible income. So that's one of the reasons why the vendor will generally retain those trade debts. If they go bad, at least the vendor gets deduction for that.

Prepayments, the price will usually be adjusted for any prepaid expenses where the services to be provided post-settlement can result in a higher sale price because the seller has already paid for expenses that the buyer will inherit the benefit of. The seller may have already claimed a tax deduction for the prepaid amounts, given that the threshold for being able to claim prepayments outright has increase significantly, more and more taxpayers are able to simply claim outright their prepayments balance year-end. A purchaser will not be entitled to a deduction for any increase in the purchase price to reflect the prepayments. So an important one to watch there.

Similarly, on the accrual side, a price will usually be adjusted for accrued expenses to the date of sale, and that may include not just ordinary creditors, but it could include wages for employees. Those sorts of items, again, may result in a lower sale price, because the buyer will be required to pay the expenses when the invoices or the due date payment comes in, and these should have been paid and are attributable to the period the seller owned the business. Again, seller's not entitled to a deduction for the adjustment paid to the purchaser. So another little tax one to watch out for there.

Employee leave is a big one. So when a business is sold, employees will usually be offered employment by the purchaser in the new business, or if the purchaser is buying the business to fold into an existing one, and the employees are surplus to their requirements because they've already got sufficient coverage, the employees may be made redundant. So for redundant employees, the seller will generally be required to pay out unused leave entitlements and any redundancy payments. For continuing employees, the seller and purchaser will generally adjust the purchase price to reflect any leave liabilities that are assumed by the purchase of both annual and long service.

The liabilities when we're doing that adjustment are calculated in respect of employees' current pay scales, and traditionally, and we still see this, the adjustment is affected by reducing the sale price of the business. It's effectively where no payment is being made and we've got an adjustment, it just forms part of the capital sum for sale. It's not deductible to the seller and not accessible to the purchaser. However, in the odd circumstance where there is actually a payment being made for leave, the seller can claim a deduction for any of what are called accrued leave transfer payments under Section 26-10 of the '97 Act. So an accrued leave transfer payment is a payment that an entity makes in respect of an individual's leave when the entity is no longer required or is about to stop being required to make payments in respect of such leave and the payments required under an Australian law award or an industrial agreement.

So as mentioned, an actual leave payment, a physical payment is deductible to the seller under Section 26-10, but on the flip side, it's accessible to the purchaser under Section 15-5. So that's the alternate to simply adjusting capital proceeds to take into account the liability. If you're just adjusting proceeds, you don't need to worry about these deductible or accessible provisions. These only apply where there's a physical payment being made by the seller with the purchaser getting the benefit.

So as I say, 9 times out of 10 or 99 times out of 100 even, the employee leave is simply dealt with by way of an adjustment to the purchase price by the agreed amount of the provisions outstanding at settlement. But the amount of the provisions is then tax adjusted to reflect the fact that the purchaser will obtain a tax benefit when they physically pay the leave provisions out. So that adjustment will generally be either 25% or 30%, reflecting the corporate tax rate of the entity, and that adjusts the purchase price down by 75% or 70% of the accrued leave entitlements. So again, we're recognising the fact that the purchaser will get that tax benefit in the future and making an additional adjustment to our leave adjustment to reflect that benefit that they get.

Let's jump back into our case study and look to apply some of these things that we've just discussed to UCS. So the balance sheet of the company just prior to sale of business was as follows. We've got $200 grand cash at bank, $200,000 worth of trading stock book value, $100,000 in debtors, a million in plant equipment, $500,000 in other liabilities, giving us a net asset position of a million dollars with our two shares that was it Jim and Helen have got and retained earnings comprising the balance in equity.

So if we recall, based on the term sheet, the purchaser acquiring a trading stock, plant equipment and goodwill. So for trading stock where we're selling outside the ordinary course of a business, we know we're deemed to have sold it at market value. So market value for a wholesale sale,, as we discussed, is likely to equate to its costs or its book value. So in this case we can say we've sold our trading stock for $200,000. Being its book value, we've got no gain or loss under the trading stock provisions for tax purposes.

Plant and equipment, it's assumed that the market value in the books approximates its tax written down value, and we'll assume that UCS operates on a tax equals accounting basis for its plant and equipment. So where we sell for its tax written down value, we don't have to worry about a balancing adjustment arising on sale. Obviously, where the market value is different and the parties either agree to a different value to tax written down value or we are deemed to not be dealing at arm's length, the balancing adjustment may be triggered.

So in this case, we will say that UCS has been doing the right thing, we're dealing at arm's length with our purchaser. If we allocate proceeds to plant equipment based on its tax written down value, we're selling for a million dollars, and we've got no gain or loss to worry about on sale for tax purposes. As we've mentioned earlier, there's that tension. The purchaser will be desirous of allocating more proceeds to plant and equipment simply because they will get a tax benefit from that payment sooner.

So a total capital proceeds of $3 million will be allocated as follows. We've got trading stock of $200,000, the plant equipment of a million, and goodwill of $1.8 million, which is our residual value. It has a nil cost basis, it was all internally generated. If we have goodwill that has pre-CGT status, the capital gain is disregarded, and the sale becomes tax-free. In this case, the business commenced in 2003, it's post-CGT. We therefore have to think about, well, we've got a $1.8 million capital gain. Are there any other concessions that we can consider, which brings us to CGT small business relief.

So in our background facts, just a little bit more, Jim is 54 years of age, Helen is 52 years of age, and we noted in our earlier point that neither have previously applied the CGT Small Business Retirement exemption. Helen plans to retire once the business is sold. From this, we can assume Jim is required to stay on to help with handover, which is often the case. It might be have an employee, a key employee required to stay on for anywhere between one and three years to help with handover of key relationships, show how the business operates, give the purchaser an idea of how, say, to run the key players, those sorts of things. As Jim and Helen each own a 50% interest in the company, they're each therefore entitled to 50% of the voting power dividends paid and distribution of capital from the company.

So small business relief provides a capital gain arising on certain assets to be reduced, either in part or in full. A number of basic conditions must be satisfied, and once we do, the following, concessions become available. We've got the first one, the gold standard being the 15-year exemption, which is a full exemption from CGT where an asset has been held for greater than 15 years, provided, and these are additional conditions that apply only to the 15-year exemption, that you are over 55, and the disposal is in connection with your retirement. If a company or a trust directly makes capital gain on sale of a CGT asset, the company or trust needs to have had a significant individual for at least 15 years and a CGT concession stakeholder.

The second concession is the 50% reduction, and provided you meet the basic conditions, the 50% reduction automatically applies, and it also applies regardless of whether you're an individual, a trust or a company, unlike the general 50% discount. The third one is the retirement exemption, which has a lifetime limit per taxpayer of $500,000. Oddly enough, despite it being called the retirement exemption, you do not actually need to retire in order to be eligible to use this exemption. However, if you are under the age of 55, an exempt gain must be rolled over into superannuation. Again, an additional requirement if a company of trust is making the capital gain that's eligible for small business relief, the company will need to have a CGT concession stakeholder.

And finally, the small business rollover allows us to defer a capital gain for two years or longer where we reinvest in new assets or capital improvements. If we don't reinvest, the maximum rollover period is two years. You will trigger a CGT Event two years after you've elected to use it.

Two basic conditions must be satisfied for relief to be available, the first being that at least one of the following applies. You are either a small business entity for the income year, or you satisfy the maximum net asset value

test, or in circumstances where you're a partner in a partnership that is a small business entity and the CGT asset is a partnership asset, if you hold the asset passively, and it's used in a business carried on by an affiliate or connected entity that is an SBE or you hold the asset passively, are a partner in a partnership that is an SBE, and the asset is used in the partnership business. So this can extend to things like property that you hold that is used in the partnership business. The SBE test is a complete alternative to the maximum net asset value test. If you are able to satisfy the SBE test, this condition is satisfied, and you don't need to worry about the maximum net asset value test. The second basic condition that is that the CGT asset that we're selling satisfies the active asset test.

So the small business entity rules looks at aggregated turnover, and it's got to be less than $2 million for CGT purposes. I know that for other concessions, other small business rules, that threshold is significantly higher, but for small business CGT it has to be less than $2 million. So we are looking at the three tests the previous year., If we're under $2 million, then we're satisfied, even if our actual is over $2 million in the current year. If one of the previous two years is over $2 million but not both, we will be eligible small business entity provided current year turnover is likely to be under $2 million, or we can look at the actual test for the current year. If we're actually under $2 million in the current year, then we satisfy.

For UCS, its turnover is in excess of $5 million that will not satisfy the SBE test. So we then have to consider the maximum net asset value test. So to satisfy that, some of the following amounts must not exceed $6 million. The net value of the assets of yours, any entities connected with you, and the net value of CGT assets of affiliates of yours or entities connected with your affiliates.

If the asset is a share in a company or interest in the trust, you've got to be a CGT concession stakeholder in the company or trust, that is an individual, or CGT concession stakeholders in the company or trust have a combined small business participation percentage in the entity of at least 90%. And as noted, a CGT concession stakeholder is someone who is a significant individual, that is someone who has a small business participation percentage of at least 20% in the company. Quick poll question. I'll hand back over to Alison.

CCH Learning:

Thank you very much, Corey. Okay, the second poll question is up on the screen for you all. So goodwill is a pre-CGT asset if the business was commenced or required before 20 September 1985. So simple true or false for this second poll question. Perfect. Everyone's well underway voting on this second and final poll question in our webinar today. And a couple of questions have come through already. Thank you for those, and a reminder to quickly pop them into the Questions pane, and then we can add those to the Q&A at the end. All right, a couple of more seconds for those last few people, and let's have a look at these results. So 84% true. Thanks, Corey.

Corey Beat:

Thanks, Alison. I think this one actually needed a C, it depends. So without further information, yes, true, goodwill is a pre-CGT asset if it was commenced or acquired before 20 September '85. However, if it was acquired in a company and the company's had a majority change of underlying ownership and a default 149 Event is triggered, then that goodwill may not remain a pre-CGT asset. So if you pick false, then you're not necessarily incorrect. Double negative there.

Moving along, I appreciate we may be running a little tight on time, but we'll talk about connected entities and affiliates. So these connected entity provisions are critical to understanding the small business CGT concessions and the small business entity rules. It's now applying to other things, base rate entities, things like that, these concepts of connected entities. So an aggregated turnover will include the annual turnover of any entity connected with you, and connected entities are also relevant for the purpose of the net asset value test and active asset test. Connected will depend on this concept of control and the entity, its affiliates, or together with

its affiliates will control the other, or entities are controlled by the same third party, i.e., its affiliates or together with its affiliates.

So we look at control in three different situations. We could look at control of a discretionary trust, an entity other than a discretionary trust, or indirect control, which can apply to any entities. So if a company, you'll be taken to control a company where you have a right to 40% or more dividends or capital or voting. So it's not 50%, it's not the usual control test. It's actually if you get 40% or more, you're deemed to control for the purposes of these connected entity provisions. Similarly, for a unit trust, if you've got an entitlement to 40% of income or capital of the trust and partnership entitlement to 40% or more of income or capital of the partnership.

Discretionary trust rules are a little bit different just because they're different entities. There are two tests, one being a distribution test. So an entity will control a discretionary trust if the entity and/or its affiliates receive at least 40% of the income or capital in any of the four prior income years. So we could have several in four years if two beneficiaries receive at least 40% each year and they're different beneficiaries each year, we could have eight people controlling this trust when we're looking at the connected entity rules. The second point is a little bit grey in that it's an influence test. So an entity controls the discretionary trust if the trustee acts or could reasonably be expected to act in accordance with the directions or wishes of the entity or that entity's affiliates.

So we're now moving to the definition of affiliate. And an individual or a company is an affiliate of yours if they act 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. So it's important, everyone under the old rules, people were deemed affiliates based on relationship, and that's changed. It's important to note that one, trust cannot be an affiliate. It's linked only to individual companies.

And that third bullet point is probably critical. It's got to be someone who will act in accordance with your directions or wishes or in concert with you in respect of the affairs of the business they are carrying on as an individual or a company. If they're not carrying on a business, then they can't be an affiliate under this provision. We note for small business relief purposes, though, to help with passively held assets being used by entities that would otherwise be not connected, a spouse or a child under 18 may be deemed to be an affiliate to help get through those passive asset rules.

So as we've said, only an individual company can be affiliate trusts are not. They've got to be carrying on a business. A spouse or a child under 18 are not automatically your affiliate. They've got to conduct an actual business in order to be an affiliate, and then they've also got to act in accordance with your directions or wishes.

Active asset test is the other basic condition that needs to be satisfied, and a CGT asset is active where it satisfies either the following, it's an asset used or held in carrying on a business, used or held in carrying on a business by an affiliate or a connected entity, or is an intangible asset connected with a business carried on by you, a connected entity or an affiliate. And the easy example here for that is goodwill. So an active asset includes an asset you own that is used in a business by your affiliate. So in this circumstance, we have an individual who owns the premises, their affiliate carries on the business from that premises. So whilst the business is not carried on by the individual, the premises they own can still be an active asset, provided the affiliate has been carrying on that business from the premises.

How does that apply to Jim and Helen? They each own 50% of the company, which is at least 40%. That means they each control UCS. Interestingly enough, just to point out, if Jim owned 60% and Helen owned 40%, they would each initially be deemed to control UCS, but because Helen could point to Jim having actual control where he holds 60%, the commissioner can exercise the discretion to not treat her as being connected. In this case, it's 50/50, they're both connected, neither controls outright. Because Jim and Helen also hold at least 20% of UCS, they're both significant individuals and are both CGT concession stakeholders.

So let's go to our calculations now. We've got our book value in that middle column and our market value is on the left. So cash at bank trade and stock debtors are all in line with book as is plant equipment. Goodwill, we have the $1.8 million value ascribed to it. As it's net assets of $2.8 million, and Jim and Helen's only other assets are their main residence and personal use assets, which are not included for the purpose of the net asset value test, the net asset values of UCS and its connected entities will be less than $6 million, and we satisfy the net asset value test.

The active asset test, the asset disposal giving rise to a capital gain, is the goodwill in the company in the business that is capable of being an active asset, it's internally generated, taken to be acquired when the activities which give rise to the goodwill commenced. It's been owned to date, which given we started the business in 2003, is 20 years, which means it's at least 7.5 years that the asset has been active, and the goodwill will satisfy the active asset test.

Looking at our concessions, the 50% active asset reduction concession is available, and that means any gain by Jim or Helen can be, sorry, any gain by UCS can be reduced by 50%. We note below, the 50% CDT discount is applied before the 50% active asset reduction. However, as UCS, the company is selling the goodwill, it's a company, it's not entitled to that initial 50% discount, but it is entitled to the 50% active asset reduction. And we can make a choice to forego this concession to maximise our access to the retirement exemption.

We'll quickly wrap up with the 15-Year and Retirement Exemption for companies. In UCS' case, we've satisfied the basic conditions. The active asset goodwill has been continuously owned for 15 years, so we've satisfied that condition. Jim and Helen have retained their ownership over the whole period of ownership of 20 years, so UCS has a significant individual for at least 15 years during which the goodwill was owned. We've got significant individuals just before sale of the goodwill. However, because neither are over 55 at the time of the event, we don't satisfy this requirement, and therefore, the 15-year exemption will not be available to UCS.

Which means we must turn to the retirement exemption. So again, to get the retirement exemption, we've got to satisfy the basic conditions. The company must have at least one significant individual, it must make directly or indirectly through deposed entities a payment to the CGT concession stakeholders in respect of the gain to which the concession is being applied. If the CGT concession stakeholder is under 55, the exempt component up to $500,000 lifetime limit must be put into superannuation, and it's based on the age at the time just before the payment. So the payment must be made within seven days of lodgement the company returned. That includes the capital gain, and the exempt amount is deemed to be an ETP.

So for Jim and Helen and UCS, the basic conditions are satisfied. UCS has a significant individual in the year of the event, which means that condition is satisfied. Both Jim and Helen are under 55 at the time of the event, meaning the payment at this point may have to go into superannuation for both of them. It definitely will for Helen. Based on this, the payments will be deemed to be ETPs and must be made on or before the date UCS' tax return is lodged for the year. The retirement exemption conditions are all satisfied. The capital gain after we've applied the 50% reduction can be reduced by up to $1 million, being $500,000 for each of Jim and Helen.

So here's our calculation. We've got the $1.8 million sale of the goodwill capital gain, the active asset reduction reduces the gain by $900,000. We've then got the exemption payment, $450,000 each to Jim and Helen, leaving Jim and Helen with a remaining $50,000 lifetime retirement exemption limit.

Before we move on to the last couple of slides, just in respect of this particular solution, we could potentially look at using the CGT rollover to defer the capital gain by two years. That rollover would mean that if we used it, even if Jim and Helen, or UCS, I should say, did not acquire an asset in two years time, Jim would be over 55 at the time that CGT event is crystallised. So he could then take the cash tax-free. And depending on when Helen turns 55

after that CGT event crystallised in two years time, she may be 55 at the time of payment. So that's one way to again assist our clients in maximising their proceeds cash in hand on the sale of a business.

Just to finish off, we're just bang on time here. ATO are continuing to focus on both incorrect reporting of capital gains and even non-disclosure of capital gains, and they're giving specific attention to people claiming the small business relief concessions when they're either ineligible or have incorrectly calculated their claim. So in recent years, heightened data matching efforts by the ATO with state revenue offices and other collectors of information of sale information have been used to uncover unreported sales of both property and business assets. So the ATO will seemingly impose significant penalties where it identifies an incorrect small business relief claim, including shortfall penalties and the imposition of the shortfall interest charge from the date the original return was lodged until they issue their amended assessment.

And that wraps up Sale of Business, Part One for today. I will hand back to Alison. She mentioned she's got a couple of questions that have come through, and if you've got any questions, please put them in the box now.

CCH Learning:

Thank you very much, Corey. Okay, yes, we've had a couple of more questions come through, so we'll see how many of these we can get through. In the interim, I'll quickly mention our upcoming webinars. So tomorrow, we're looking at Driving Advisory Revenue, followed by Employee Expenses. Then Crypto Accounting Simplified. Also, ATO Phoenix Strategy, and then another session from Crowe on the 22nd of November, that's Division 7A Update. So jump on the CCH Learning website for all of those details. All right. So Sam and Matthew both asked what is an earn-out?

Corey Beat:

An earn-out. So what will happen in sales of businesses is that the purchaser and the vendor may disagree on the value of the business, so you might look at valuing the business based on earning multiples. The purchaser will obviously want to use lower multiples or might point out, "Oh, these results are not typical." The vendor, obviously, will think their business is worth a significant amount more. To get over that hurdle, the parties can agree to tie additional sale proceeds to what is called an earn-out, a right to receive additional proceeds based on performance of the business post-sale.

So it may be that if the business maintains a level of profitability in the 12 months or 18 months or 24 months, however long it needs to be post-sale, as a vendor, you don't want it going too long, if it meets certain profitability targets, then the vendor receives additional proceeds for the sale of their business. They don't often work the other way in respect of business sales in that the vendor pays back amounts for purchases, but it's a way for the vendor to potentially receive additional proceeds. The risks there obviously being that unless the vendor is involved in the business going forward, you lose control of the ability for the business to maintain that level of profitability. [inaudible 01:03:13]

CCH Learning:

Thank you very much.

Corey Beat:

If there's anything else on that, I'm happy to answer.

CCH Learning:

Thank you. So Sam has asked, "A Schumer Cafe's operated in a lease property and was purchased for over $100,000. If the business owner operates the cafe until the lease expires, at which point the business ceases, how is the purchase price of $100,000 treated for tax purposes?"

Corey Beat:

It would depend entirely on what that purchase price was allocated to. Is that goodwill, was their plant and equipment ... A difficult one to answer without more information, but I guess you've got that. What's happening post the cessation of lease? Have they got a new lease lined up? Will they be moving to new premises? Are they going to cease the business completely? There's plenty that can happen there, Sam.

CCH Learning:

Thank you, Corey.

Corey Beat:

I've probably not directly answered the question, but there's probably not enough, not enough info to be able to go into.

CCH Learning:

Yeah, understandable. Edward has asked, "If we applied the 50% reduction for a client who sold his company business, if the client withdrew all the money from the account after the sale, this means part of the capital gains for the 50% discount needs to be declared." I guess this is a question. So after the sale, does this mean that part of the capital gains for the 50% discount, does it need to be declared as unfranked dividend in the client individual tax return?

Corey Beat:

Thanks, Edward. Potentially, yes. So we've kind of fit quite a bit into this session, and from the start of the session, I did mention that we will be doing a more comprehensive small business CGT session in the new year. But you're right, so if the company accesses the 50% active asset reduction, you have a problem that that is an untaxed amount in the company. So unless the company has excess franking credits from previous operations, when that's paid out as a dividend, it's unfranked. But there are strategies to be able to get that amount out as an unfranked dividend, and it will involve putting the company into liquidation. So that's the potential way for that amount to come out as a non-accessible dividend, but there may then be CGT consequences arising from that liquidation.

So again, this is where the modelling upfront, getting in touch with the client before they even go to market to say, "Look, what's this business worth? What will happen if we sell the assets out of the company or the unit trust versus what will happen if we sell the shares or the units? What's the tax outcomes?" "Yes, I might get a better tax outcome immediately in the company at the 25% rate, but I've got to get those funds out somehow."

CCH Learning:

Thank you, Corey. And the last question for the moment, Jonathan said, "Can you expand on the taxation treatment of restrictive covenants?"

Corey Beat:

I guess the question is what ... I'm trying to work out what to expand on there. It's the creation of a right. So the creation of a right will trigger a CGT Event D1. As mentioned, the right only comes into existence when you create it, so it's difficult as an individual or a trust if you're creating it, difficult, impossible to get the 50% CDT discount. As noted in the slides, if there is a restrictive covenant, but you don't allocate proceeds to it, then it's simply taken by the commissioner to be part of your sale on goodwill, and that may be the better outcome for sales from a sales of business from an entity perspective. But some individuals may insist the purchase price is X for the business, and if you want me to give a restrictive covenant, that's additional proceeds, in which case if it is treated separately, it's a taxable component.

CCH Learning:

Perfect. Thank you, Corey. All right. That is all the questions that have come through for today, so appreciate you getting through those.

Corey Beat:

Thank you.

CCH Learning:

Thanks, Corey. All right. So in terms of next steps, excuse me, if I could please ask the audience to please quickly complete the feedback survey. It's important that we hear your opinions there. And in terms of the recording, shortly after the session today, you'll receive a email letting you know the eLearning recording is ready, so you can jump into the platform and access that along with the PowerPoint, transcript, and a CPD certificate as well. So thanks very much to Corey for the session today, and thank you to everyone for joining us. We hope to see you back online for another CCH Learning webinar very soon.