Commercial Considerations when Selling a Business 04/06/2024

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Hi, everyone. Welcome to today's webinar regarding Commercial Considerations when Selling a Business. I'm Alison Wood from Wolters Kluwer and CCH Learning and I'll be your moderator for today. Just a few quick pointers before we get started. If you're having sound problems, you can toggle between audio and phone, and in the PowerPoint in the handout section is where your PowerPoint presentation is saved. And shortly after the session today, we will send you an email letting you know when your e-learning recording is ready to be viewed. You can also ask questions at any point during the session today. Simply type them in the questions box and I will collate those questions and ask them at the Q&A at 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 and for CPD purposes, your viewing is logged automatically. Your presenter today is Carlo Di Loretto from Crowe Australasia an affiliate of Findex. Carlo is a partner and provides taxation advice on a broad range of taxation issues to many Crowe Australasia clients, including privately owned businesses and public companies. Carlo's expertise covers small business relief, capital gains, restructures, and GST-related advice. He works with individuals, partnerships, trusts, and companies from many industry groups including property investment, manufacturing, mining, technology, engineering, and retail. So without any further ado, I will pass you over to Carlo to commence today's presentation.

Carlo Di Loretto:

Thank you very much, Alison. Hello everyone. And to those of you who are regulars here, welcome back for this session today, which is more of a practical and commercial session. And it relates to two other webinars that we've run in recent months that really is helping us to work out a way of advising clients who are considering selling or purchasing a business.

Today, we want to focus on things that are partly tax-related but are partly commercial and legal. And we'll start by having a look at the look-through-earnout rules that were brought into the legislation probably about eight years ago now. And these are a common feature of a lot of business sales these days, so it's good to get a bit of a pressure on that. We'll touch on just some very general GST matters to consider. Also, transfer duty, always a big issue, especially... Well, if you're a purchaser, you've got to consider that and then we'll cover some due diligence matters that you might want to consider.

Also, the legal agreement, a lot of us probably do leave things to the lawyers to deal with, but it's very important that we keep an eye on the legal documentation because a lot of legal practitioners probably don't practise a lot in the tax sphere. So that's where we can really add a lot of value to a client in working with the solicitor to get things like the tax warranties and tax indemnities right. And then finally, I'll just take you through a very simple stepped process, how you can actually help your client manage a sale process. And as we'll see when we get to that, a lot of the work actually starts several years before any sale is actually contemplated, and it's an area where we probably need to be proactive so that the client really ends up being in the best position when they make that decision to sell to business or should an offer come from an unexpected purchaser.

So let's start with a bit of a brief recap on what we've covered in our previous two webinars on sale of business. We considered two options for the sale of a business, one being the business asset sale and one being the sale of an entity. And I'll take you through a structure shortly just to remind you of the very simple case study we covered and we looked at the two different options. So the first one was a sale of a business assets from a company and there were two shareholders, Jim and Helen. And we looked at the issues around selling the goodwill, selling the other business assets, applying small business relief, and we also had a look at the ways of accessing the failed proceeds. One of the problems you'll have is if your client operates a business through a company and they sell business assets, the sale proceeds are trapped in the company.

And we looked at what are the ways you can access those proceeds. And the two main ways would be dividend and a liquidation of the company. And that's what this option one looks like. So Jim and Helen own the shares in Underground Cables. Underground Cables carries on the business and then a purchaser comes along but wants to acquire the business assets only. So underground cable sells its business, of course, the sale proceeds end up in the company and then you have a secondary matter then to deal with is how do Jim and Helen effectively access those sale proceeds? And when we compare the two options for accessing the proceeds, we saw that the liquidation in this situation gave us a better outcome. So about $280,000 better off, and that certainly outweighs any cost of liquidating the company by a long way. So it's a very good idea to go through this process with your client so you can give clients some hard factual information on which to base their decisions.

The second option we considered was where Jim and Helen sell the shares. So you can see that immediately after the sale, the purchaser owns Underground Cables company and the associated business. The benefit of this approach is that Jim and Helen receive the sale proceeds directly. So you don't have the secondary issue of getting any sale proceeds out of a company. So that's all well and good and when we compared that option with option one, you can see that option two in our scenario gave us by far the best outcome. So option two gave us about a half-a-million dollar advantage over asset sale with a dividend and about a $230,000 advantage over sale of assets with a liquidation. So I will say from the outset, this is not always going to be the case because it will be very much dependent on your circumstances.

And if you haven't had a chance to go back over the two previous webinars we've covered, that'll be available on CCH Learning to see how we got to these numbers. But it is a process where you do have to go through and do the calculation because it's not always the case that a share sale will necessarily give you the best results. And then there is also the commercial which you've got to overlay over that. And that slide here just really summarises what I've just gone through. So that's really what we've covered in the previous two presentations or webinars. Now we'll jump to today's first topic, which will be earnouts and clawbacks. So what's an earnout clause? Many sale agreements have these days. Broadly, it provides for additional consideration to be paid to the seller and it's usually dependent on some kind of economic performance threshold being met.

Typically, it's profit, and depending on the situation, it might be an EBITDA figure. So earnings before interest tax, amortisation and depreciation, or it could just be achieving a sales level. There's many ways these can be defined and it's quite a good way for the seller to get additional consideration from the business, but it is based on future profitability. So it works both ways. It can also be useful for a purchaser to limit their initial payment and that reduces the risk to the purchaser of the business not achieving the level of profit that they thought it would achieve when they went through the due diligence process. So if you are a seller, what you really want to do is you want to limit the percentage of these contingent sale proceeds. So you want to get as much upfront as possible. And the other thing you want to do is keep this time period as short as possible, and typically we see two to three years would be quite common.

And as we'll see shortly, the legislation does actually limit it to five years to get what we call look-through treatment. Clawbacks are the reverse. The clawback enables the purchaser to be refunded part of the purchase price. So it's a reverse earnout, and again, it's where the purchaser pays all of the proceeds upfront, but if a certain profitability or other measure is not achieved, they can get part of that sale proceeds back. So don't see clawbacks as much as we see earnouts being inserted into sale agreements. Earnouts, look, I won't labour this first slide too much. It's there really just to give you a bit of a historical overview of what's happened here. There's been a lot of uncertainty with earnouts for many years. There's always been technical arguments about whether we should apply a look-through approach versus the separate asset approach.

And the ATO have traditionally taken the view that an earnout right is an asset in its own right. So what that means is when you sell a business for cash and an earnout right then that earnout right is in itself an asset and then that means you are receiving that asset for your sale and you need to then work out, "Well, what is the value of that earnout right?" It's a difficult thing to do and it requires probably a professional valuer to give you that valuation. So the value of that right is included as your total capital proceeds for the sale. The problem also is that when that earnout right is paid out, you'll have a CGT event because your earnout right is cancelled or expires. And if that's a capital gain, well, you probably wouldn't qualify for things like small business relief and if it's a very short-term right, you may not even get the 50% general discount.

So there was really big problems with this. There were also a couple of rulings. This one here from 2007 was never finalised and there was an older one 93/15. Both of these were withdrawn in December 2016. And then in that year, in the 2016 year, we got the legislation that then made an earnout look through rights. And that's what we'll talk about in a moment. So this is when the draught legislation came out. It was around April 2015. It took a few months for it to get over the line, but finally made it into law on the 26th of February. And that's the law we have now. Hasn't really been subject to a lot of change. But, importantly, what a look-through earnout right does is the earnout itself is disregarded. So you don't have any more problems with valuation and with those rights expiring or being satisfied for the buyer, anything that you provide under a earnout look-through forms part of your cost base, and for the seller, anything you receive from that earnout relates back to the capital proceeds or the sale of the business.

In other words, you just completely disregard the earnout as a right on its own, and sale proceeds or payments are just back to the underlying asset that is being either purchased or sold. You have to be careful though. Look-through treatment doesn't apply to all earnout rights. You have to meet a number of conditions. So I thought I'd just take you through these briefly. The first one there is it's got to be a right to future benefits that aren't reasonably ascertainable, which means there's got to be some doubt as to whether or not those future payments will actually arise. It's got to be involved in a disposal of a CGT asset and that disposal's got to trigger event A1. Now A1, as you probably know, is where there is a change in ownership of an asset. The asset's got to be active and we'll talk about that in a bit more detail later.

All of these benefits under the right have a time limit. They cannot exceed five years, which is not a problem because I don't believe in practise because I've never really seen many go beyond say three years. But just be aware there is a time limit at which you can apply, look through treatment, it's got to be contingent on economic performance and typically they are. So typically, there'll usually be a requirement for a certain benchmark profit to be achieved. So that would be an example of economic performance and being contingent on meeting that particular threshold. And the benefits need to reasonably relate to that economic performance and in most cases it's quite straightforward to demonstrate that. And of course, the last one, they're always very important. You've got to be dealing with each other at arm's length. And again, I would say that in most situations that will be the case, but that is designed to prevent collusion happening between arm's length parties.

So it's not the nature of the relationship, it's the way in which you're dealing with each other that the arm's length test applies to. So very important to remember that distinction. In terms of active assets, so that's one of the key conditions for look through. It takes you back to the small business relief definition in 152-40. So just briefly, it's an asset that's used or held ready for use in the course of carrying on a business. And it can be by the actual entity itself or it could be an affiliate or a connected entity. It can be an intangible. So for example, goodwill. Goodwill is an intangible asset as things like copyrights and trademarks and what have you. Even patents could be sharing a company or an interest in a trust quite often, and I'm seeing this a lot more in practise these days, is buyers want to buy the entity rather than the underlying assets.

Quite often, that's because the business is heavily reliant on written contracts and agreements and leases and what have you. There could be valuable patents in a company name, therefore legally it makes it much easier to acquire the entity. So just be aware that there is an 80% look-through calculation you have to do for entities. So the underlying assets must comprise at least 80% by market value of active assets. So don't forget that that's an important one that is easily overlooked. So you can see that the look-through rights are not straightforward. You need to go through this analysis. For active assets, be aware there are some exceptions. Financial instruments like loans for example, cannot be active, or where their main use is, for example, to derive passive income like interest or rent or what have you. So just be aware of those limitations. If you do qualify for the look-through treatment, then when you receive an earnout, so if you're a seller, then you simply add those additional proceeds to the capital proceeds, if you're a seller, or to the cost base if you're a buyer.

But you do that when you've received or paid the amount. So what that means for the seller is you may have to go back and amend an original assessment because you may not be getting this payout for a couple of years after sale. So just be aware of that. The amendment period is extended for this. So you have up to four years after the year in which the additional proceeds are received. If you make a loss from your original transaction, just be aware you can't use that capital loss until all of the earnout rights have been extinguished. So there's a deferral on the ability to claim a capital loss. And then for the purchaser, you just adjust your cost base to reflect the earnout payments that you've made. These rules are prescriptive, be very careful with them. It does provide I think, much more certainty now, but you do need to meet those eight conditions that we worked through.

There is an administrative burden, you may have to amend tax returns and you may have to watch out on using capital losses. But I think what it does do is it gets rid of the problem that we've always had. Is, "How do you value these, what are they worth? And then what happens if the proceeds from the earnout exceed the earnout's cost base under the old rules." Now if you don't qualify for look-through, be aware the old treatment then may continue to apply. So it's very important to try and satisfy these rules. There's a simple example here, which I might leave you to have a look at in your own time, but it's about Alice. She sells her shares in her business. I think we might just look at the diagram and she receives a million dollars cash plus an earnout right. And the example just talks you through what actually happens.

So she gets some proceeds, she then gets a further... So she makes about a $400,000 gain, let's assume, on the initial million-dollar sale. That's all quite straightforward. She meets the first threshold and therefore gets another 100,000. So her total gain increases to 1.1 million and therefore she would have to go back and amend the original tax return because of this extra $100,000 in sale proceeds. And then this interesting situation happens here where the purchaser decides they want to end the arrangement early. So rather than having to pay or wait, wait to determine whether a further amount is payable, they just offered to pay Alice 50,000 to forego that further payment. She accepts that and then that 50,000 is just treated the same way as any other earnout payment would. So her total capital proceeds then go to 1.15 and total capital gain of 550, which again may require another amendment depending on the timing of things and what have you.

There's a simple example there that just shows you how it works. There are choices that obviously need to be made with capital gains that could be small business relief. These have all been adjusted to take into account the earnout right that's received. So you might have to remake some choices. Be careful with small business relief. Because of the way look-throughs work, you could have a problem with the net asset value test. So if the sale proceeds increase, be very careful if you're close to the $6 million threshold for that, that could put you over. And there's also timing requirements to be eligible, particular concessions. Tax consolidations. What you may have to do is if you're acquiring a company, bringing it into a consolidated group, then you might have to revise your ACA calcs for the membership interest in the entity you're acquiring because of the extra proceeds you're paying. So a few things there to look at as well. Okay, Alison, I'll hand over to you to run our first poll question, please.

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Thank you very much, Carlo. All right. This one I can launch straight up on the screen for you all. So which of the following is not a condition for look through earnout rights? A. Active asset condition, B. Five-year time limit condition, C. Applies from the 24th of April 2015, D. Applies to the sale of shares, E. Sale gives rise to CGT event A1. Perfect. So many of you underway voting on this one. Others, if you're looking for how to participate, just find the blue or orange flower icon on the bottom of your toolbar that will bring up Go to Webinar in its entirety, and then you can click in one of these five radio buttons. All right, slowly getting up to majority here. I'll just give those last few people a couple more seconds and let's have a look at everyone's results together. Okay, so we had 60% on D. Thanks, Carlo.

Carlo Di Loretto:

Thank you, Alison. Well, that's brilliant. Well done if you said D, that's the correct answer. So it is not limited to just say the sale of shares or the sale of units in a trust. It can equally apply in the case of a sale of business asset quite commonly used. But just be aware, we've covered today, there's about eight broad conditions that you need to meet. So if you are confronted with a client who is entering into a sale agreement and there is an earnout there, just be aware, you will have to give the client some advice on how that earnout is going to be treated. Because if it's not a look-through, then you're most likely going to have the old scenario applying where the earnout is a separate asset. And we've already talked about the downside to that being the case.

Just moving on, I thought we'd just touch briefly on the GST. GST as you know broadly applies to most transactions if you're registered or required to be registered. So sale of business assets, generally that's going to be a taxable supply. So in the first instance, you're looking at GST being 1/11th of the sale proceeds. Now, if land is involved then the margin scheme could apply, so the GST might be less, but there's no GST if your sale qualifies as a going concern. If you meet the conditions in section 38-325, if it is a going concern, that's going to be GST-free. But all the input tax credit in relation to expenses and acquisitions you've made connected to that sale are then available to you. So very important to understand when a supply is going to be GST-free as a going concern. The first thing is you've got to provide or supply all the things necessary for the continued operation of the enterprise and you've got to carry on that enterprise until the day of the supply and it will be GST-free if you've got consideration.

Now in virtually, all cases when you're selling your business to a third party, that is going to be the case. Both parties have to be registered and at least the purchase should be required to be registered. And you've got to agree in writing. Now, typically, that'll be in the sale agreement, but it can be in a separate document, but very important to ensure that it is documented. Now you need to be careful because if your client is selected for an ATO review, especially if they're a Top 500 or a Next 5,000 client, they'll almost certainly ask you about the going concern exemption if you've claimed it during the review period. And specifically what they're interested in is making sure that you've applied all of the things necessary. That's the area where a lot of GST-free treatment has been personally knocked back by the ATO.

So you really need to have a look at this ruling 2002/5. It's quite a comprehensive ruling. It is actually not a bad one, and it goes into detail about the going concern in many different scenarios. It’s too big to cover today, but it is a really good ruling and I strongly recommend you have a read of it. If your client is selling their business, some of the interesting things out of it, you can sell part of a business and use this going concern exemption provided that part is an enterprise in its own right. So that might be possible where you've got a client with several divisions in a broad business and they just want to sell off one of the divisions. It can be GST-free depending on the circumstances. Generally, a business sale would have to include premises if that enterprise requires premises to operate from. So that can be a bit of a tricky one. Many businesses don't require premises, but if they do, just be aware. This is a way in which the ATO seek to limit this GST-free treatment.

And one of the big concerns is if premises are required, but the purchaser already has their own, so you run the risk of not being able to meet the GST-free requirement. So just be careful there. Also really important that you can demonstrate that the seller has carried on the enterprise right up until the day of sale. And by day of sale, we mean the day on which completion occurs. So when the transfer of the assets takes place. So the enterprise has to be active and operating on the day that the supply occurs. You can have a temporary cessation and that doesn't mean you'll fail the test, but it just depends on the circumstances. So be very careful. We've talked about the agreement must be in writing. The law doesn't tell you how this should happen, but I think the safest way, and most lawyers will do this is they'll include it in the sale contract.

You need to be aware though, just because you have it in writing in the contract doesn't mean you have a GST-free supply. You still have to meet the other conditions that we've talked about. So if the requirements are not going to be met, then you're going to have GST on the sale of your business. These are business assets. So then you have to start thinking about the cash flow and you might want to think about perhaps deferred payment terms to reduce the initial outlay of GST, but just be aware it is only a timing issue. So GST liability on the one hand, generates an input tax credit on the other, and of course, the contract will most likely cover you, but you should make sure that it does. The ability to recover GST in the event that you think the going concern is going to apply and then you subsequently find out that it doesn't.

You need to make sure the contract has a good GST recovery clause in it as well. What about if you sell the entity? Well, it's very different scenario. You're not even in GST-free territory. If you sell shares, that's going to be a financial supply. So there's no GST payable to the seller. Unfortunately, you also aren't going to get input tax credits, especially if you've incurred costs like for example, valuation costs, accounting fees, legal fees, consulting fees, any of those that are directly related to sale, unfortunately, would not be available to you. So just be aware that that is one of the limitations of going through an entity fail. Just moving ahead, I think the next thing we then have to consider is duty from the point of view of a purchase. So just about every state and territory in Australia has a duties legislation, or either transfer duty or stamp duty.

Couple of states still use the old terminology, particularly South Australia and Northern Territories still refer to the old Stamp Act, whereas the other states and territories have updated their legislation. For example, in WA, that was updated to the Duties Act back in 2008 and New South Wales, Victoria, Queensland, Tasmania, ACT have all done the same. The main difference is that in the rewrite dates, the law is now that there is duty on the sort of transfer of dutiable property, whereas under the old legislation, the Stamp Act type legislation, it was basically the traditional approach, which was... It was a duty on instruments or documents that evidence transfers of specific things like land or what have you. So just a modernization really and nothing more. So these are the legislation that apply in the various states or territories that you may find yourself in.

So there are differences between these acts. So please refer to the ACT in your specific state, but that's there just for your reference. Transfer duty is duty that's payable where you transfer dutiable property, that's in the rewrite states and that's what we'll focus on today. So dutiable property, pretty widely defined, that would include things like goodwill, intellectual property licences, etc. It's usually payable by the transferee. So now language that means the purchaser and it's a comparison of the actual proceeds or the consideration paid or the unencumbered value, but typically in an arm's length transaction, you'd find that the consideration is the value. So that's the important thing. Also for duty purposes, just remember it's the unencumbered value. So if you are acquiring an asset and assuming a liability, you're paying it on the value of the asset and you disregard any liability that you assume with that asset.

So just be careful there. When you've got a sale of a company transfer duty firstly on many business assets has been abolished. So I've given you the dates there. So you can see the ACT, New South Wales quite a few years ago, Tasmania and South Australia, a bit more recently. In Northern Territory, just last year, WA and Queensland still have duty on business assets. Victoria apparently never imposed this. So what that means is, yeah, we need to give thought to structuring and depending on the state that you live in, so for example, if you're in WA, you might get a much better result selling shares or units than you would by selling the underlying assets.

So it's a benefit for the purchaser, but if the purchaser wants assets and you find that you do your analysis that I've showed you at the start of the presentation today and you work out that you're in WA and it's better for your client to sell the shares, there's a real bargaining point there that you can really sell the fact that there is a significant transfer duty saving to the purchaser and then you can probably meet them part way, give them a bit of a discount to pay for some additional due diligence that needs to be done.

There's some planning there. You can use all of these things as bargaining chips. There's also landholder duty. Landholder is really looking at an entity. So you might sell shares in a company and landholder duty applies if the company has significant real property assets that it owns. So it's a bit of an anti-avoidance rule. So to stop people transferring land indirectly, and as I mentioned, you've got most states now don't charge duty on the sale of shares and this is an anti-avoidance rule that if you are transferring shares, say in a land-rich company, you'll pay duty on the transfer of those shares. So I've just summarised the main features of this briefly for you. I know you're probably not all going to be interested in every state, so rather than go through them all, I'll just leave them up here for you to have a look at.

But you can see that in New South Wales, the threshold for when landholder duty might become payable is if the entity has land with a value exceeding $2 million. So that's the first thing. And then the second thing is duty typically only applies to what we call a significant interest. So in New South Wales, for example, a significant interest would be 50% or more if it's a private company or 90% or more if it's a public company and if it's a private unit trust it's 20%. So you can see that you can probably deal in public company shares without having to worry about landholder duty at all. But for private companies, just be aware if you're acquiring a majority interest then you may be up for some landholder duty. You can see in Victoria the threshold for land-rich is a million, so it's a lot less than New South Wales.

And the significant interest again varies. You can see 20% for private unit trusts, 50% for private company, 90% for public. In Queensland, it's also $2 million and 50 and 90 as a significant interest. And in WA, again, $2 million is the threshold and 50 and 90 seems to be quite common. For Tasmania, the threshold is quite low, half a million dollars. And for the ACT there is no threshold and the significant interest is 50%. So quite an interesting approach there. Northern Territory also half a million dollars is your land-rich threshold and 50 and 90%. Now interestingly, in Northern Territory, they have an integrity provision there. So for a public landholder, significant interest drops to 50% if there's a scheme for tax avoidance. So just be careful there if you're in the Northern Territory. Shares and units basically really have been done away in most states, as you can see here. I've tried to go back and just find the dates that this happened, but you can see New South Wales is probably the more recent one in July 16.

So that's all quite good. Now, as I said, probably as I practise mainly in WA, the biggest disadvantage there is that duty is still levied on business assets like goodwill. So it even makes structuring from an individual to a company or a trust to a company quite an expensive exercise. So just moving on now to some more practical matters and that is the due diligence aspect of a purchase and sales. So let's have a look at the first bit, which is negotiating with purchases. And the key objectives of undertaking a due diligence is so that we can discover if there's any significant tax liabilities and using that information we can adjust the purchase price. So a due diligence is really something that's needed by the purchaser if they're acquiring an entity like a company or a trust. So you may need to obtain some warranties and indemnities and what have you, which is all incorporated into the contract.

You also want to be able to quantify any tax losses and franking credits and whether there are any restrictions on their use and also to really then develop a tax-effective acquisition scheme. So again, mainly from the purchaser's point of view, very important to do this if your client wants to acquire a company or a trust, and as I've found in recent years, entity acquisitions are becoming more common. At this point, you also want to consider asset sale versus entity sale and they're in the first two webinars that we've covered a few months ago worth having a look at if you haven't sat through those yet. Looking at what's the compliance history like, looking at the compliance processes, are they solid? Is there good governance in the company or trust that you're buying? Look at the ATO audit history. Have they got private rulings? Look at specific issues, especially for example, if you are buying an entity that is in construction and they have long-term contracts.

So is that being treated correctly? Are there any tax-driven transactions? These are the sorts of things you'd cover in due diligence. The materiality very high spot, "Okay, this is not a detailed audit, there is a materiality to be applied. You're really going to focus on the significant matters." If there's carry forward losses, you'd really want to make sure that you have some comfort as to whether those losses can be utilised. If you're acquiring a trust, beware of the trust loss rules. If you're acquiring a company, continuity of ownership is going to be broken, but then can you satisfy the business continuity test? So same business or similar business test, will you be bringing that entity into a tax consolidated group? So there's a bit of an analysis to be done there to see what's going to happen with your ACA. Has there been prior changes in ownership?

Because again, if there's losses you might find that there could be a problem with those. At an earlier point in time, have a look out for things like debt forgiveness or will debt be forgiven as part of pre-sale restructuring? That's one of the things we always have to do. If a client is selling their business and they're selling the entity, one of the things we always have to do is potentially a cleanup of that entity. If there are assets and debts in there which are not related to the business, unfortunately, you do find that some clients will use their company for example, for all manner of things and that will all need to be cleaned up sometimes before a sale can be completed. Look at the financing structure. Be very careful with things like debt and equity rules and think cap, especially think cap if your client is an overseas entity.

Debt-equity rules are also very important. So are debts going to be true debts or are they going to be non-share equity and what have you? Be careful on tax deductions for acquisition costs. If you're representing the purchaser, have a look at things like black-hole expenditure and then tax consolidation regime, need to be very careful with that. If you're talking about bringing an entity or another tax-consolidated group into an existing consolidated group, lots of things to check out there.

In terms of black-hole expenditure, just be aware it only is available for capital expenditure and it's really a provision of last resort. So if you qualify to use this, it's straight line over five years, but be very careful to make sure that that expenditure doesn't already fit into some other category like cost space, for example. There was a recent case a couple of months ago that was on this very point where the taxpayer was unsuccessful in arguing black-hole deductions because the expenditure just qualified as cost base instead for CGT purposes. So I'll just leave that here for you to consider, but it's a tricky area, not as straightforward as we sometimes think it is. Okay, Alison, I'll hand over to you to run our next poll question, please.

CCH Learning:

Thank you very much, Carlo. Okay, everyone, this second poll question is up on the screen ready for you all. So the going concern exemption can apply to the supply of shares. So we're just looking for a true or false statement for this second and final poll question in our webinar today. Thank you everyone for getting your votes in for this one, and a couple of questions have come through already, but quick reminder, if anyone is thinking of questions during the session, please pop those into the questions pane and we will address those in our Q&A. We've got 15 minutes left on our session today. All right, I'll just let those last few people get their votes in on this poll, and let's have a look at these results. So 61% false. Thanks, Carlo.

Carlo Di Loretto:

Brilliant. Thanks, Alison. Thanks, everyone for having a go at that. And if you selected B, you'd be correct. That is false. So we covered that in the presentation. That sale of shares is going to give rise to a financial supply, so that's input taxed. So the downside to that is while there's no GST liability, there's also a loss of input tax credits on any expenses that are incurred in that sale process. So thank you very much for having a go at that. And we might then just move on to the last couple of bits of the presentation today. And that's just really to have a word on some of the legal aspects of the sale. So we're going to have a look at things like warranties, indemnities, and just legal documentation generally. So it's really important that whilst we might be tax agents or tax advisers or accountants, it's really important that we get involved in overseeing the legal documentation.

And I just know, in my own experience, that lawyers are very knowledgeable in what they do, but they'll be the first to tell you that tax is a foreign language. And I understand why tax is very, very difficult and a lot of the lawyers that you deal with are commercial lawyers, so they're not necessarily specialised in taxation. That's why it's really important for us to work with them and to review the legal documentation from a taxation point of view. We are often pretty close with our clients. So one of the things we can do is just to make sure the contract reflects what our client has negotiated and is expecting.

Expectations are really important. A lot of negotiations sometimes are quite frenetic and there's a documentation going backwards and forwards. It's always good for us to get a clear understanding of what the client wants and making sure that the contract reflects that. As part of that is the warranties and indemnities we need to have a look at. So when a purchaser acquires an entity like a company, they're going to take on the past problems of that company. So they'll need some risk management and they are the warranties. So there'll be a very extensive warranty clause in the share purchase agreement and the effect of that is to give the purchaser a right to claim compensation should something come up. And look, there could be a variety of many reasons for that. The warranty is all basically revolving around the amount paid for the business and whatever the seller is warranting. In the case of the business, usually there's a maximum compensation and that's set as a percentage of the sale price of the business.

There is some exposure to the seller because until that warranty period runs out, there is a risk that the purchaser may make a claim on that. So for the purchaser, the limitations really are the credit position of the seller. Will they have the money at the time that a claim is made? There could be some legal costs to enforce the warranty because that is a legal matter and there may be some argument over whether the warranties apply. It can be difficult to enforce. Again, it comes down to the wording, not something we can do much about. That is a legal matter, but there might be for example, a subjective element in there, and a classic one is where you see the words to the best of the seller's knowledge that can make it very difficult for a purchaser to enforce a specific warranty. There's often a minimum threshold.

So rather than every single warranty arising, typically what you have is a process whereby there might be a number of different claims of small amounts, but unless they reach a specific threshold, then no claim can be made. And that's a good system. It stops us spending a lot of time and money with lawyers on dealing over a relatively minor claim. So there is an element of that that purchasers may have to understand that. And usually, there's a sunset clause and a cap on the amount of the compensation. Very important that it has those things in the legal agreement. The purchaser will want to minimise their exposure to tax problems of the past. So there's usually a very specific tax warranty in the agreement as well. And that gives the purchaser the right to claim compensation for past tax liabilities that come up after the sale's been completed.

And these are generally not capped. So sellers need to be very careful as part of the sale process. That's what we'd want to do as their advisors thoroughly go through the last few years' tax returns in detail, perhaps in more detail than what we would normally do in preparing the returns, and almost do something akin to a prudential review where we drill down into underlying documentation just to be extra certain because you don't want the seller to be surprised down the track if the company gets audited after the sale and therefore we want to have some comfort in that for the seller, basically your exposure increased, you could have more payments to make quite a long time after the sale price has been agreed to. So very important that we restrict the time period and that's again a negotiation. There's no fixed rule for this, but clearly as short as acceptable to both parties.

A couple of other things to look out for straddle period tax returns. So the agreement will need to address the situation where shares in a company are sold part way through the year. So that's going to be a straddle tax return. Typically, we'll have to prepare some completion accounts, it may need some kind of proforma tax return as well done at that time to really apportion tax liabilities pre and post the sale. Another really important matter from a tax point of view is getting access to information after completion. So, if you're a purchaser and you're buying a company with an extensive history, you really would want to at least be able to access all the information for all the assessments that are open in respect of that company, which could be four years into the past. So very important, this all has to be discussed and negotiated as part of the sale process. Don't forget tax information and the access to it pre and post the sale, very critical.

The final bit that I want to cover today then is... We've got a client, they want to go through a sale process and I guess you can apply this to clients that are purchases as well. There's a process that we can follow, and I really like this because I think this is where we can show a lot of value to clients and this is where we can show them that we are not just tax geeks, that we actually can provide some really commercial and useful advice and guidance in probably what is for most of our clients, the most important transaction they'll ever do in terms of in the financial field. And that is sell their business. Many clients, they'll only ever do one of these in their whole lifetime.

So they're not going to be experts and therefore we are in that position to really be seen as expert advisors to them. Sadly, the research doesn't support that this is the case right now. Many business people don't think of accountants as the relevant person to advise on a business sale, especially at the smaller end of the scale. They think business brokers and lawyers are the ones to speak to, but we want to change that because what is happening at the moment, a lot of us are not finding out about a business sale until the very last minute. We'll call it the 11th hour, but you know what I mean.

As a result, we don't get a chance to put in place a decent structure for that sale. Could lead to the client to pay more tax than what they need to and it doesn't give us the time to work out the best option for selling the business, which is the first two webinars that we've run in this process. So I think the challenge for us is we want to change that perception and this process that I'm going to take you through, hopefully, we will help you to do that. So if you've got a client they want to sell their business, please have a think about the steps I'm going to take you through. The first one is very preliminary and I think it starts with a succession planning session for any client who's thinking about selling their business in the future.

It doesn't have to be for clients that have already started down that track, anyone who's just merely thinking about it. And to be honest, every client who runs a business must be thinking about this every now and then, even if they're not ready to sell right now. So you do a succession planning session. We usually run these over two half days and we take the client through all the options for selling the business. But what are these options? Well, there's a trade sale, a management buyout. If your client has really good management in their business, they might want to buy the business. Maybe the client wants to pass it on to a family member, maybe to a child. Perhaps this business is going really well and it might be good to go public with it so we can talk to them about the IPO process or they might want to sell a significant stake to a new investor with the view that eventually that investor will take out 100%.

And then finally perhaps through a liquidation of the business if another route is not acceptable. So they're the broad ways in which to realise the business value. So once you've had a chance to do these succession planning process with the client, then I think it's really important to get an understanding of the health of the business through a business diagnostic. So that's where we look at where are the strengths and weaknesses of the business. Can the business be operated independently by the business owner? That one is a really important one because that will have a huge influence on the value of the business. And the other thing is, can we improve the profitability? So one thing to consider is we can show enormous value to clients if we can help them improve their business. So working on the business with them, you've got to remember that if a client is in an industry where let's just say value is three times net profit, very simply, if you improve your profit by $1, what that means is you've added $3 to the value of that business.

So very important that the client work on their business to really just maximise its profitability and that just naturally leads to increase in the value of the business. So very important step. The other thing to do in the next step is to get a valuation of the business because you can't think about a business sale if you don't know what the business is worth. Also, highlight any problems that potential buyers may find in the business. So this is where we really put on our devil's advocate hat and through the first two steps work out well these are the things we need to work on to improve matters so that there's more value there for a buyer to acquire the system with these problems and get the business ready for sale and then advise on a fair market price. One of the things about a business valuation is to do it at the start of this process because that is one way to demonstrate our value to them.

If we do evaluation right now, it's a benchmark. We may not sell for two or three or four years, but we can measure our effectiveness. If we can improve profitability, make the business run better, that in three years time the value should have increased. That is the test check, but very important to have an understanding of what that value is. We might also then have to seek out potential buyers if the seller wants to take on a more active type of sale. And that could be just in the same city within Australia or perhaps from overseas as well. The next step then is really the tax implications of selling. And that's what we've really covered in the first two webinars in this series. So what is the best way to sell? Do we need to do some tidy up before the sale can take place?

Is there any restructuring that needs to be done? I mentioned earlier on the entity that you want to sell may have assets that are not business-related, so some tidy-up might need to happen. All of this needs to happen before a sale can really take place. The earlier you consider these things, there'll be less pressure as we get closer to crunch time. Step five is, if there isn't one, prepare one if there is one updated. But a business plan is essential and this is where you really have to sit down with the client or the client may already know this, but what are the steps that they need to take to really maximise the profitability of the business? Because as I've covered that increase in profit will lead to a multiple times increase in value. So very important. The next step is now we're really starting to get into the new degree of the sale itself and that is an information memorandum.

If anyone's interested in buying, the first thing they'll want to know is, "What am I buying?" So there needs to be this document which sets out the key things of the business. So the financial details, things like management reports, the business plan, due diligence information buyers need something to run with. You can also use this to make confidential approaches, which is often done. If a buyer is interested, then you might need to issue them with a confidentiality agreement and then you could release that information memo, you deal with any questions and you request non-binding indicative offers. And that's usually what kicks off the sale process for real. Then we look at what the purchaser is offering and then we need to analyse those offers and the terms. We then need to put together the due diligence information, and that typically sits these days in a data room electronic.

We then assist in managing that process and we help to deal with questions from the due diligence teams and we sometimes provide that data room, but there are many off-the-shelf ones that are available these days that we've come across that are very good. We also assist with negotiations. So again, with earnouts, the price, the payment terms, and this is where we work with the lawyers so that the financial and commercial is correctly reflected in the agreement. Very important. Finally, you get to that what is going to be the final sale price after all of the due diligence and the negotiations and the discussions have taken place.

So, while a business sale for SMEs, I would say is typically tax-driven. It shouldn't be, but it is because that's where we can really fine-tune the net after-tax sale proceeds. There are really a lot of areas where specialist advisors are going to be needed. And I'm not talking now about tax and accounting anymore, I'm talking about things like valuation. So you will need perhaps a corporate finance specialist to do that. Depending on the size of the business, you may need what we call lead advisory services. So our corporate finance team usually does things like that, especially for larger sales, and just always bring in specialists where you think you need them. So don't try and do everything yourself. It's always good to call on people, especially in the area of business valuations who can be a little bit independent and therefore takes a bit of the pressure off us. Okay, that's all I have for you today. I'll hand over to Alison now to run through any questions and close the session.

CCH Learning:

Thank you very much, Carlo. Okay, so a couple of questions have come through. If anyone else wanted to quickly pop one in the questions pane, please do so and then we will add those to our Q&A. All right. In the interim, I will quickly mention our upcoming webinars. Tomorrow, we are looking at high-net-worth individuals and access to aged care. Then at your best at all times in regards to high performance, also our anti-money laundering phase two session, then a session on SMSF annual return, so mid-year budget, and also how to negotiate payment plans with the ATO. So if you jump on the CCH Learning website, you'll see all the details of those sessions. All right, Carlo, so first question here is from Edward. The client, which is a company structure, bought a parcel of land on April 2023 and built two townhouses, and then sold it in May 2024. The transaction is in the revenue account. Can the land and building in this scenario be classified as an active asset or is it just trading stock?

Carlo Di Loretto:

Yeah, that's a really, really good question. I'm going to have to make some assumptions here, Alison. So by active asset, I think you are asking active asset for small business relief purposes. So, if you are, then the fact that it's on revenue account means that small business relief is not possible. The only other thing you may be referring to, are you referring to earnouts. Possibly. And it could very well be an active asset if it's not being used predominantly for rent. But the question I would have for you though is if it is on the earnout, just make sure you've gone through and checked all those conditions. I can't really give you a definitive answer on very limited facts, but the active asset definition is you've got to be using it to carry on a business. So in that particular scenario, you've got to ask yourself the question, "Is the company carrying on a business say of property development?" It's possible, but yeah, too hard I think to give you a definitive answer. But yeah, you need to probably do a little bit of research there. But good question. Thank you.

CCH Learning:

Thank you very much, Carlo. There's also a few questions about the previous two parts to this webinar, so correct me if I'm wrong, Carlo, but I'll send people the links for the session that we ran in March of this year. So how to best extract funds when selling a business? And then the other session was sale of business and that was in November of last year.

Carlo Di Loretto:

Yes, I think they're the right ones, Alison. But that's right. These three webinars basically can be taken as a set and if people haven't attended those, if they want to have a look at those, I think it'll lead in nicely to some of the topics we've raised today. Thank you.

CCH Learning:

Yeah, perfect. Thank you, Carlo. Just let everyone know when I send out your recording email, I will add the links to those two webinars so you can access those as well. All right, so that is all the questions that have come through for today. So I will just take you through our next steps now. There will be a feedback survey that pops up. Please take a moment to pop your opinions in there. Shortly after the session today, you will receive an email letting you know when the recording is ready. You can also access verbatim transcript, CPD certificate, and of course this PowerPoint presentation. So thank you again to Carlo for the presentation today, and thank you to everyone in the audience. We hope to see you back online for another CCH Learning webinar very soon.

Carlo Di Loretto:

Thank you, Alison.