How Best to Extract Funds when Selling a Business 05/03/2024

CCH Learning:

Hi everyone. Welcome to today's webinar regarding How Best to Extract Funds when Selling a Business. I'm Alison Wood from CCH Learning Wolters Kluwer, and I'll be your moderator for today.

Just a few quick pointers before we get started. If you're having sound problems, if you open up the audio panel, you can toggle between audio and phone, and your PowerPoint is saved in the Handouts section. And shortly after today's session, we will send you an email letting you know when your recording is ready to be viewed. You can ask questions at any point during the session today. Simply type them in the questions box. I will collate those questions and ask them in 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, and for CPD purposes, your viewing is logged automatically.

Your presenter today is Carlo Di Loreto 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 Loreto:

Thank you very much, Alison. Hi everyone, and welcome to our presentation today, which is really looking at the best way, or the ways, in which to extract funds from an entity once a business has been sold. So quite often we are dealing with clients who operate their businesses through structures like private companies or unit trusts, and the issue will come up as to, well, once the business assets have been sold, how do we get these proceeds out to the shareholders? So we'll look at today getting the proceeds out of an entity where business assets have been sold, and there's two broad options, there's dividends or there's liquidations, and we'll compare that with the tax implications with selling the entity rather than the business assets.

So many people might be thinking, "Well, it's very hard to sell an entity." I'd differ with that view, but rather than go into the ins and outs of that, I think what we'll do is firstly recap on a case study we ran in a previous session. So hopefully all of you attended the sale of business webinar, which my colleague Corey Beat presented back in November 2023. If you didn't attend that, I'd strongly recommend going to that. You can get that from CCH Learning.

But in that presentation we set up a case study involving Jim and Helen. Jim and Helen are the two shareholders of a company called Underground Cables Pty Ltd (UCS), and they each hold one share, which they received back in November 2003 when the company was established. So the business basically started up from scratch. It grew very well over a number of years, turnover exceeded $5 million, they employed 20 staff, and in the previous webinar we saw that they sold the business assets out of the company. And we know historically that Jim and Helen had not applied any CGT small business retirement exemption before that.

So just to summarise where we landed in the previous webinar, we can see that the company sold the goodwill for 1.8 million. It then applied the 50% reduction as well as the retirement exemption. So Jim and Helen each took 450,000 as a retirement exemption, and due to their age, that would be paid into their complying superannuation fund. And we saw from the last webinar that there was no capital gain in the company, so the sale was effectively tax-free. Now you can see that Jim and Helen haven't applied their full retirement exemption. They each have $50,000 remaining from their lifetime limit. So just bear that in mind.

So what does the balance sheet of the company look like? I think that's the first thing you've got to ascertain when a company is about to sell the assets of a business under a business sale. So typically, this is a very simplified version, but the book value on the left is what you'd see in the financial statements where the business is started within the company, there's generally no value of Goodwill provided. You can see that it's got some debtors, some trading stock, bit of cash, and some liabilities and two dollars of issued capital and some retained earnings of just under a million dollars.

So the first thing we want to do when we're trying to advise clients is just, we need to restate this balance sheet to something that resembles market value. So we know from the previous webinar, the goodwill we sold for 1.8 million, and we assume that things plant and equipment were just sold at tax written down value. And the big assumption there is that that approximate market value for that plant and equipment, not always the case, but in a lot of instances that can be a reasonable assumption.

So you can see that when the sale happens, if you look at the after sale column, you'll see the cash obviously increases. The trading stock, plant and equipment, and goodwill are gone from the balance sheet, and what we have left is some debtors and other liabilities. So your net assets remains at 2.8 million, but your retained earnings have now increased substantially to just under 2.8, because we only have two dollars of issued capital. The next column shows you the retirement exemption being paid out, and then the final column, you see what is left over in the company. So net assets of 1.9. So most of that is retained earnings, two dollars of that is issued share capital.

So worthwhile going through this, because this sets up the starting point. That final column on the right is what we have to now deal with, is how do we access those net assets of 1.9? So going over the page, this just summarises what I've just taken you through, so no need to go over this again, but this slide here really talks about what's left over in the company, and in particular the retained earnings. So it's just under 1.9 million, but when we break that down, we can see it's comprised of two things. It was retained earnings leading up to the sale of just under a million dollars, plus 900,000, which is attributable to the active asset reduction. That's the 50% small business reduction. So we have to remember that, because that's got a very special treatment as we'll talk about later.

So the question becomes, how do we access this almost $1.9 million of I guess net cash, as it were? There are two taxing points when you're looking at extracting funds out of a company following a business sale. The first taxing point is the sale of the assets, which we've covered in our previous presentation, and the next taxation point is at the shareholder level. And at the shareholder level in this business sale scenario, there are two options. We pay dividends or we liquidate the company.

Now when you're advising clients, this is the opportunity to provide real value. Many times we take the approach, "Well, the client's asking us a technical question," like, "Does small business relief apply?" or "Are dividends taxable?" or "Are franking credits available?" I would suggest that that's not the question we want to answer. I would suggest what we want to do is what we're going to do in this presentation today, and that is present the options to client in the language they best understand, and that is net after-tax cash in the hand.

That is the most important thing. And as we go through today and we compare the options, you can see that when you provide the information to the client in this way, you are providing them real value information that then they can make decisions on. So with that precursor in mind, if we pay dividends, we're going to retain the company, okay? But what we have to do is call in the receivables, pay out the liabilities, and then that 1.899, just shy of $1.9 million, gets paid out as a dividend to the shareholders. And we're going to say that yes, we can frank that dividend to the extent of the franking account, and let's just assume that there are plenty of franking credits in this case, but that's not always the way, but always check the franking account. But for simplicity, let's assume it can be fully franked.

So this is what the calculation looks like. We've got a dividend of just under 950,000 to each of the shareholders. We've got some franking credit gross up, and we'll assume 25% tax rate applies to this company. You can see the gross up there, and then tax at 47%. Just to keep it simple, we'll just assume this is all going in at top marginal rate of tax, but you can finesse that if their other income is low or non-existent in the year. But for simplicity, let's do it this way. We then claim the franking credit, and you can see the top-up tax payable in the shareholder's hands is about just shy of 560,000 in total.

Now, when we convert that to an after tax funds amount, we can see the dividend is all cash, top line there, less the top-up tax. You can see the net after tax cash amount is around, in total, $1.34 million. But don't forget they've also got 900,000 in super through the retirement exemption. So you can see that total after-tax funds, which is comprised of cash and super, is about 1.12 million each, 2.24 all up. So that's the result if you go down the dividend path. The other option is liquidation. So in a liquidation, what happens is, well, we liquidate all the remaining assets and pay out the liabilities. In this case, it's very simple. All we have to do is call in some debtors, which the liquidator will do, and he'll pay out the liabilities and then you'll be left with a net amount to pay out.

Now, when you extract funds through a liquidation, couple of things happen. You have a deemed accessible dividend, and that's because section 47 of the 36 act applies to distributions by liquidator. And generally speaking, the only thing that gets excluded from accessibility, really, is the two dollars of share capital. So there's an accessible dividend, plus there's a CGT event on a liquidation, and that's when the shares are cancelled. So typically that would be like a CGT event [inaudible 00:12:25] so they're the two things that happen.

One of the things that's interesting on a liquidation is the way the 50% reduction in the company is treated. Now remember we said, of that almost 1.9 million in cash, 900,000 relates to that small business reduction concession. Or the ATO have a view in TD 2001/14 that that amount, that 900,000, is not income according to ordinary concepts, and will not treat that as a dividend for section 47 purposes. However, it will form part of capital proceeds for the cancellation of the shares, which is the CGT event. So that's quite important.

So when we look at how this flows through, we'll just flow through this in totality, the liquidator's going to pay out a full 1.9, and two dollars of that will be share capital, which is not a dividend. The 50% reduction is not a dividend either, which means the total accessible dividend is only just shy of a million dollars in this example, so just under half a million for each of Jim and Helen.

Now we then have to do the CGT calculation for the cancellation of the shares. So you can see the full 1.9 is the capital proceeds. The cost base is only two dollars. And we get to remove from that the accessible dividend that arises under section 47, so the just shy of a million dollars of accessible dividend, which leaves us a gross capital gain of 900. And then to that, we can apply the 50% general discount. We can then also apply the 50% small business reduction, and we have a hundred thousand dollars left of retirement exemption that Jim and Helen can apply, and that leaves us a net gain of about a hundred and twenty-five thousand shared equally between them.

So that's the tax position. What does it mean from a cash point of view? Well, we can see total cash is 1.9. There's some tax payable of about 350,000. That leaves us about $1.55 million in net after-tax proceeds. But we've also got now a million dollars in super split evenly between Jim and Helen, and therefore the total after-tax funds on a liquidation is just shy of $2.55 million. So a little bit better than what you get from a dividend. And you can see the comparison there.

There's an advantage in liquidating in this scenario of about $305,000, and that's very valuable information for the client to know, and that's why we go down this approach. They're not necessarily interested in the ins and outs of section 47 and CGT of [inaudible 00:15:31], but they're very interested to know that there's an advantage to liquidating over a dividend. So that's why it's important to set things out for clients in this particular way. Okay, Alison, I'll hand over to you to run our first poll question for today, please.

CCH Learning:

Thank you very much, Carlo. Okay, I will launch this one straight up on the screen for you all to click in your selections. So how are liquidator's distributions treated in the hands of a recipient? A, capital receipts? B, ordinary income? C, capital gains? D, dividends? Or E, all of the above? Perfect. So many people underway voting on this one. For the others, if you're looking for how to participate, you'll find a blue flower icon on the bottom of your toolbar, and that brings up "Go to Webinar" in its entirety, and then you can click in one of these five radio buttons.

All right, I'll just give those last few people a couple of seconds to get their votes in, and let's have a look at these results. So we had 47% on E, 19% A, range on the others. Thanks Carlo.

Carlo Di Loreto:

Thank you Alison. Thanks everyone for having a go at that. Look, this was not a straightforward question, so I can understand people saying all of the above, because yes, they are treated as capital receipts, especially when you have a C-II event happening to the shares. Certainly that also means capital gains, and they're also dividends. Questionable on the ordinary income, but I can understand saying that. My probably preferred answer would be D because of section 47, but I think those who said all of the above, you guys are actually quite well onto it that you've seen elements of all of these things happening on a liquidator's distributions.

The reason it's a capital receipt is because many of you probably came across a case called Archer Brothers many years ago, and that really is very important for how we look at liquidator's distributions, so basically liquidator's distribution is always on capital account. So that's why I don't particularly like option B, ordinary income, but certainly C and D are also very relevant as well. So thank you very much for having a go at that. So my apologies, this was a bit sort of difficult I guess, because quite a few answers would be technically correct.

So let's move on now to the next bit. So we've talked about retaining the company and getting funds from the sale of business assets out of the company, but there is always another option, and that is to sell the entity itself. Now, I know many people think this is not really possible, especially in the small business space, but in my experience, what I'm about to take you through now will really get clients to rethink this option as a seller, to really seek to negotiate commercially the sale of the entity, but it needs to be in the right circumstances.

So we'll go through now this next bit to see the sort of situation where a share sale actually gives you a pretty good result. So when we say we're going to sell the entity, typically we're either going to sell all the shares in a company or all the units in a unit trust. You're not going to sell a discretionary unit trust. I've seen people try to do that, it just can't really work. But they're the two main entities that you would typically sell in a SME or owner managed business environment. Definitely a cleaner option for the vendor. Unfortunately for the purchaser, they inherit any liabilities or problems within that company. But certainly for the vendor, you don't have to worry about apportioning sale proceeds. And we covered that in the first webinar back in November last year, so again, if you haven't seen that one worth having a look at that.

So the first thing you have to do is, when you are contemplating a sale of the entity, you need to look at the CGT status of the shares or units, and have a look to see if any of them are pre-CGT. Now in our case study example they're not, but you must check the pre-CGT status of your very old structures. And the thing you have to look out for is CGT event K6. Most people think, "Oh, we've got pre-shares, we can sell these, and no capital gains tax to pay," and they completely forget the integrity rule in K6. So K6 looks at the underlying assets of that pre-CGT company. And if the market value of the post assets is 75% or more of the net value of the company, you are potentially going to have a capital gain when you sell those pre-shares.

Now the thing to look out for here is, the market value of the property is compared to the net value of the company. We are not comparing apples with apples here. Market value of the assets is a gross number, but you're comparing that to the net value of the company, which is a net number. It's assets less liabilities. So while 75% might sound like a lot, you've got to make sure you compare it to the right denominator, and that is the net value, if it's a company with a lot of liabilities, your net asset position may be relatively low compared to the market value of all your assets.

So you need to be very careful with K6 and make sure with all pre-CGT companies, you have a look at this. So this is broadly what you're looking at. You have pre-CGT shares in the company and you have to look at the assets and liabilities of that underlying company to work out whether K6 applies. Now, if it does apply, the capital gain is only the extent to which the value of the post assets exceed their cost base. So again, that will just depend on the circumstances. And if K6 is triggered, it applies when those pre-CGT shares are sold.

Have a look at TR 2004/18. That talks about K6 in a lot of detail. It's a very comprehensive ruling. If you haven't looked at it before, please have a read of it, especially if you've got clients that have pre-CGT private companies and unit trusts. Very important to be aware of that. The other thing we want to look at is accessing small business relief. So if you're selling a share in a company or a unit in a trust, there's some additional basic conditions you need to meet. So you have to be a CGT concession stakeholder in the company or trust, or CGT concession stakeholders in that entity must have a combined small business participation percentage of at least 90% in you, and "you" means an interposed entity. So very much targeted at structures where you might have a discretionary trust owning shares in the company or units, so we'll have a look at a diagram about that in a moment.

So a CGT concession stakeholder is what we call a significant individual or the spouse of a significant individual in that entity, provided the spouse has a percentage in that company or trust which is greater than zero. So let's not worry too much about that, because I've got an example coming up in a minute to illustrate how that works. So we've talked about 20% is the threshold to be a significant individual. You need to satisfy this to meet the CGT concession stakeholder test when you're selling shares or units. You don't have to worry about that if you're selling business assets. So this CGT concession stakeholder test only applies if you're selling an entity. You need to be a significant individual for the 15-year exemption, either if you are claiming that in the company or unit trust or if you're selling the shares or units, and you also need it for the retirement exemption if the gain is made by a company or trust.

And when you calculate this number, it's not just the direct interests, it's also the indirect interests as well, and I've got an example which will show you that in a moment. So one of the things about this, and this is where it gets tricky, is that the small business participation percentage is the smallest percentage of the following things. So you have to look at voting power, dividend, and capital distribution rights in a company. If it's a trust, you need to look at your income and capital entitlements. If they differ, you must take the smallest amount, and that can create some problems. If you've got a discretionary trust, then you work out the small business participation percentage based on the distribution of income and capital. If you don't make a distribution out of a discretionary trust in a year, then there is no percentage in that year. So you don't fail it, it's just that it has no implication in that particular year.

And again, within direct percentages, you basically take your successive direct percentages and it flows up through a chain, which is an example which I've got here. So we've got an operating company that's wholly owned by a discretionary trust, very common holding structure in our space that we operate in. And you can see that in this year the trust distributed 80 percent to Samantha, 15 to David, and five percent to Ian, but David and Samantha are spouses. So I'll leave that there for you to just have a quick look at. So that's the distribution. 80 percent to Samantha, 15 to David, five to Ian.

So how does the small business participation percentage work here? So Samantha's got a percentage of 80% in the discretionary trust, and her indirect percentage in the operating company is 80% times a hundred percent. Hundred is the trust's percentage in the company. So she has a total participation percentage in the operating company of 80%, and that makes her a significant individual of that company. David gets 15% from the discretionary trust, so when you flow that through, he's also got 15% in the company, but he's not a significant individual, because he has under 15%. So he's not a significant individual in that sense. But David is a CGT concession stakeholder, because he's the spouse of a significant individual and he has a percentage greater than zero in that company. Ian unfortunately only has five percent, so he is not a significant individual and therefore cannot be a CGT concession stakeholder in this type of structure.

The other thing you have to look out for when you have a discretionary trust owning a company or unit trust is this 90% test. So that's the only time you have to worry about it if there's interposed entities. And the 90% requirement is that those people holding at least 90% of those participation percentages must be CGT concession stakeholders in the underlying company or unit trust. So in our example, that would be operating company. So we've got to have at least 90% of participation percentages held by people who are CGT concession stakeholders in operating company.

And we can see here that Samantha, well, she's a significant individual and CGT concession stakeholder. She's got 80%. David is also a CGT concession stakeholder. He has 15% of the discretionary trust. Ian isn't, he only has five, but we've got 95% here of percentages held in the discretionary trust that are held by CGT concession stakeholders. So you've met that particular test in order to apply small business relief. So just be aware, this is an easy one to lose sight of. Very important when you've got discretionary trust holding structures.

Now, I mentioned you have to compare, for companies, voting, dividend and capital rights. Very important to look at companies where they have, for example, a mix of voting and non-voting shares, redeemable shares or preference shares or perhaps dividend access shares. These could have a big impact on your percentage calculation. So when you are looking at your percentage, you have to look at voting power, dividend entitlements, distribution entitlements, and the only shares you can exclude from this analysis are redeemable shares.

So things like dividend access shares would be taken into account, as would non-voting shares or preference shares. So if the voting dividend and capital entitlements are different, then you've got to select the small or smallest percentage. So what if in our situation, Helen's one share was a non-voting share? Well, that means she has zero percent voting entitlements. You would have to use zero for the percentage calculation, and therefore her smallest percentage is zero and she would not be a CGT concession stakeholder or significant individual in the company. So really important to make sure you review all the shares on issue and all the rights behind those shares, because it can deny a person the ability to access small business relief.

There's also dividend access shares. These are really, really common. So if you've got a dividend access share, then arguably no individual has a right to receive at least 20% of dividends paid. And if the company pays, for example, all of the dividends to a dividend access share, which it can potentially do because these shares are typically discretionary, this means that no other shareholders could receive dividends in a year. Now the company could pay nothing to the dividend access shareholder and pay all the dividends to others. But the fact that this discretionary element exists means that you run the risk of failing the significant individual test if dividend access shares are on issue. So again, you need to do your due diligence whenever you're considering small business relief, and especially with a share sale.

So Jim and Helen, they have 50% voting dividend and capital entitlements each, because we're just assuming here that they just own ordinary shares, and that's quite common, but it can get more problematic when you've got more family members involved and it's not desired to give them voting rights, and they might only have dividend access shares, you really need to do something with those dividend access shares before you sell an entity. So both Jim and Helen are going to be significant individuals, and they're both going to be CGT concession stakeholders in our case study. So they want to apply small business relief to the sale of shares. They've got to satisfy the basic conditions. We're not going to worry about the small business entity test, simply because the company has a turnover of over five million dollars. We're just going to look at the net asset value test. So we need to look at for Jim, Helen, their connected entities, and their affiliates.

So what we do is we start making a list of all of the assets that everyone in the family group owns. Jim and Helen have a home. Jim's got a boat. They have an investment property. They have some shares in listed companies. Helen has a vintage car, and they have super. When you add all of those up, that's about $5.46 million. They're just their personal assets. Then we go and look at the connected entities, and we're going to assume that obviously the company that they're selling is connected, but they've also got an investment trust with net assets of 500,000 and a trading trust with net assets of a million dollars.

And we'll assume to keep this workable that there are no affiliates involved. Therefore, we need to work out the net asset value of Jim Helen, the company we're selling, the investment trust, and the trading trust. So that begins to look a little bit like this. So we've put the market values down there, and you can see that when you add all of those up, it's just under $9.8 million. But not all of these assets are included in the net asset value calculation. So the main residence is out, specifically the boat is out as a personal use asset. So is the vintage car. Superannuation is out, because that's specifically excluded. So when you add up what's left over, you can see that we have $5.6 million, which is under the six million dollar threshold, so we satisfy the net asset value test.

Now we've covered if you sell shares in a company or a unit in a trust, you've got to meet, in this case, the CGT concession stakeholder test. You don't have to worry about the next bullet point down, the 90%, because Jim and Helen own the shares directly. We've talked about a CGT concession stakeholder is essentially a significant individual, which is a person that holds at least a 20 percentage point interest in the company. They both satisfy those requirements, so they're both CGT concession stakeholders. Both of them meet the third condition.

Now, the other thing you have to think about is the active asset test. So I'll put some points down here for you to have a look at, but when you're selling shares or units, there is a look-through test that you have to consider. You have to look to the underlying assets of the company and satisfy yourself that at least 80% of those assets are active assets. And be careful. Some financial instruments, such as loans and options, cannot be active assets, so be very careful with things like division 7A loans. However, other financial instruments can be, provided they're inherently connected with the business, and they can count towards the 80% threshold. Be careful of any assets whose main use is to derive interest or rent. So your div 7A loans or a classic example there, they cannot be active assets at all.

So with a share or a unit, it's an active asset at a point in time. So that is just before the shares are sold. That's when you've got to do your analysis. So you look at the market value of the assets that are active, financial instruments that are inherently connected, any cash that's inherently connected, and that's got to be 80% or more of the market value of that into these assets. So very important to check this out. Don't overlook that.

So when we apply it to our case study, we know that UCS has some cash, but that's inherently connected with the business, and we're going to just say in this case that we've got active assets completely. Just be aware of cash. If you've got cash that's useful working capital, that's fine, but if you've got surplus cash that's invested in things like term deposits and what have you, it's highly likely the commissioner's going to argue that those amounts are probably not inherently connected with the business. So it can get a bit tricky with companies.

So then we move to the concessions. So we've satisfied the basic conditions. The first one we'd consider is a 15-year exemption, and you must retire in order to take advantage of this. So that's not happening here. We'll assume that Jim and Helen are under 55 and they're not retiring, so we can't use that, but we can use the active asset reduction, which requires no further conditions to be met, and we can apply the balance of the retirement exemption. So each of those, we can use up to half a million. So that works well.

And then the next thing we've got to do is work out well, okay, we want to sell the company, but what amount do we sell the company for? So here's our book value, again, straight from the financials, and here's our market value. And that's based on enterprise value. So when they were initially approached by the buyer, the buyer said, "I want to buy your business, paying 1.8 million for the goodwill." And we're doing this in a very basic way because it's a simplified example, but we're going to use 1.8 as a market value of goodwill, and we're going to assume all the other assets have market value equal to their written down value.

So what this means is when we plug these numbers in, our net assets is 2.8 million, and that's what we'd be looking to sell the shares for, to be on the same footing as selling the assets out of the company. Because when you sell the company, basically the buyer takes everything that's in the company. Now, typically what happens is in the course of negotiations, they'll say there are certain things that they won't pay for. One of those things is excessive working capital. So sometimes you have to do a bit of tidy up before the sale can happen.

You might have to pay out some dividends, you might have to collect some division 7A loans, you might have to pay some loans that the shareholders have lent into the company. We're not going to go into that today, because we want to try and keep this workable in a webinar style presentation, but there's some other things that you might want to think about as well that we haven't factored into this example. So the estimated market value, as we're saying, it's 2.8 million. That's the sale price for the shares, and this is how we allocate the capital proceeds, 50% to Jim and 50% to Helen.

So hopefully fairly straightforward at this point. So now we have to do some CGT calculations. So we can see the capital proceeds are 2.8 in total. So we'll just go down the right-hand column. We only have a small cost base of two dollars, not capitalised in any great extent at all, so our gross capital gain is just shy of 2.8, and then we can start to apply our various reliefs. And the first one is the general discount. Then we can apply the 50% reduction, and then the retirement exemption. So you can see that after applying all of that, we only need to use about 700,000 of retirement exemption. So Jim and Helen do not have any CGT liability arising if they sell the shares, which is great.

Then what's their net after-tax position? Well, they've got cash of 1.4, then they've got to roll some of that into super because of their age, they can't keep that in their own hand. So their net cash in the hand is about a million and fifty. Actually, I think that might be a typo there. Yeah, oh no, it's about right, a million and fifty. And then we've got about 350 of that in superannuation, so the 1.4 is really split between cash and super. So in total they're left with net cash and super of 2.8.

So how does this now compare with the two options we considered earlier? Well, we saw that liquidation gave us a $305,000 advantage over paying a dividend. That's if we did an asset sale. But if we do an entity sale, there's another 250,000 on the table that's available to our vendors. So that's a significant saving. It's over half a million when compared to a dividend and 250,000, roughly, compared to a liquidation. So when you presented this to the client, you can see they'll want to gravitate to the sale of shares. And that opens up a lot of commercial considerations. We can't cover that today, but in June we'll be covering commercial considerations on a business sale. So it's another part of this little series that we've created.

But it's when you present the information to the client in this way that they get the most value, and this is what I love to do the most, is sit down with clients and just walk them through these options. Not get buried in the technical detail of what is an active asset, what is a significant individual? Most clients, their eyes glaze over when you start talking about that kind of stuff. But when you start putting numbers like this, cash in the hand and where that cash is located, whether it's in their hands or in super, this gives some information they can make decisions on and be guided by. Okay, Alison, I'll hand over to you to run our next poll question please.

CCH Learning:

Thank you very much, Carlo. All right, everyone, the second and final poll question is up on the screen for you all. So which of the following concessions requires a significant individual to retire? A, 15-year exemption? B, 50% reduction? C, retirement exemption? Or D, small business rollover?

All right, so just the four options for this second poll question. And as mentioned, this is the last poll question in our webinar today, and we've had, I think it's four questions, five questions come through today. So thank you to everyone for popping those into the questions box. We've got 15 minutes left on the session, and yeah, we'll make sure we fit in the Q&A at the end.

All right, we'll look at closing this poll off and having a look at these results. So 53% A, 41% C. Thanks Carlo.

Carlo Di Loreto:

Thank you, Alison. Look, those of you who said A would be correct. It's an unusual way that they've chosen the wording here, using the word retirement exemption when no retirement is actually required. So the retirement exemption is the $500,000 lifetime limit. 15 year exemption is you need to be over 55 and have held the asset for at least 15 years continuously. Very difficult to apply the 15-year exemption in the case of companies and trusts. I've actually not had many situations where I can use a 15-year exemption, but certainly the retirement, we use that all the time, and small business rollover as well. We'll talk about small business rollover a little bit towards the end of this session today.

So I thought it would be worthwhile to have a look at some variations to what we've talked about today. And one of the things is, and you should look out for this every time you are advising your client on a business sale, always important, the very first step that I always look at, regardless of whether we think it's going to be an asset or a company sale, the very first thing I do is I go back to the company or unit trust register. I have a look to see who are the shareholders or unit holders, and for those shareholders, when were they allotted or received their shares?

So what about if Jim and Helen received another nine shares in November 2014? So they started off with one each, they end up with 10 each. What does that do for our analysis that we've done today? So the main problem is probably going to be for the 15-year exemption, if that applies. So that could have been a concern if Jim and Helen were over 55 and they were selling their company to retire or selling the business to retire.

Now, if you're selling the business, it's probably a lot easier, because the company can show that it's held the goodwill for at least 15 years, so that's great. But if you've got a share sale, then potentially you've only got one share out of 10 that each shareholder has held for at least 15 years. So that means only one 10th of the shares could qualify for this exemption. So if you've got this type of scenario, when you do your comparison, it could be that the asset sale produces a better result. So there's a little bit of a spanner in the works for you to think about in your client's situation.

But the real issue then becomes, well, what of these additional nine shares that we've issued? If they're in allotment, then the 15-year holding requirement would be a problem. But what if they weren't in an allotment? So the way in which these shares are issued are really important. If it was a share split, so converting one to 10, then that's not a CGT event, and the commissioner says so in TD 2000/10. So if it was a share split, then all the 10 shares are still deemed to be acquired back in 1993. Now, very important that you get the Corps Act method right if you're trying to argue a share split.

So again, these are the sorts of things you need to investigate when you're reviewing the share register. If it's not a share split, then you really need to do the analysis to determine whether an asset sale or a share sale will give you a better result. What about 15 year and pre-CGT gains? So if you've got a company and they sell a pre-CGT asset, normally there'd be no CGT in the company because it's a pre-CGT asset, not subject to CGT. Then you have to think about how can we get this out of the company tax-free?

Now if it's a dividend, that's not a very good idea, that's just unfranked. Marginal rates of tax will apply. But it's possible to get this tax-free by liquidating the company where there are pre-CGT shares. And that's because the principle that the ATO accepts is, pre-CGT capital reserves, when they are passed out to pre-CGT shareholders, is not a dividend. So they take that as being a distribution of capital. And because it's pre-CGT shares that they're receiving that amount for, then there's no CGT to pay at all. So again, something to look out for.

In terms of unit trust, the situation is not so clear cut, because we've got E4 to worry about. So E4 could apply if you distribute that type of gain to the unit holders where they hold post-CGT units. So be very careful there. But again, another variation or spanner in the works, perhaps, to think about in these sort of scenarios. So if the 15-year exemption would have applied, had the asset been a post asset, and the gain would've been disregarded, the company or the trust can pay that disregarded amount in a tax-free manner.

So it's going to be quite effective. If a company sells a pre-CGT asset and either some of the shares are post or liquidation is not desired, you may be able to extract a tax-free capital gain under the 15-year exemption. So a possible opportunity there, but again, depends much on the circumstances that you have. Another thing to think about is the effect of death. What if Jim died recently, like yesterday? What happens to his shares?

We know that under division 28, that's kind of a death rollover. So the beneficiary or the legal personal representative is taken to acquire Jim's shares on his date of death, and let's assume that Helen inherits those. They acquire those shares at the date of death, which is March 2024, so that's not very good news for things like the CGT discount, especially if those additional [inaudible 00:51:12] shares were issued and they were under a share split. Helen's acquisition date becomes right now, and we lose all of Jim's original acquisition date, which goes back to 2003.

So generally the 15-year exemption can't apply for Helen on the disposal of shares because she hasn't held these for 15 years. But what if Jim was 57 when he died? So at the moment he's not, but what if your client is over the age of 55, and they'd held the shares for more than 15 years? So assuming that in Jim's case it was a share split, so the acquisition date goes back to the original date of the first share, so he's held them for more than 15 years, Jim could have applied the 15-year exemption, provided he was prepared to retire. He could have also applied the CGT discount, and if the retirement exemption applied, he wouldn't have had to roll that over into super.

So if you look at 152-80, this looks at the effect of death. And if a CGT event happens within two years of death, and if Jim, as the deceased, would have been entitled to reduce or disregard the capital gain, then the beneficiary, or in this case Helen, stands in his shoes. So she could apply the 15-year exemption if Jim was 57, and even though she may not be 55 yet. So very important to be aware of these provisions which can operate. But of course it only is relevant if Jim was over 55 at the time of death. If he is under 55, unfortunately these things won't help, and Helen will inherit a more recent acquisition date. So different timing, then, for 15-year exemption, and also 50% general discount.

So the last bit that I want to talk about today is also some planning opportunities. So these may or may not be useful. Unfortunately with small business relief, there's very few general rules that are applicable in all situations. So you really have to do the hard yards and look at the specific situation that your client is facing. And one of the opportunities that we've looked at in the past is the small business rollover concession, and very useful if a company makes a capital gain and the shareholder is a CGT concession stakeholder who is 53 years old, so not able to use the 15-year exemption and must roll over any retirement exemption into super.

So what you can do is you can use the small business rollover to defer the capital gain for two years. Now you don't even have to have an intention of acquiring a replacement asset. So the way this works is once you've applied all the other concessions, let's assume you still have a net capital gain remaining, or just use the replacement asset rollover for two years. And then what happens is in a couple of years time, you're going to have a CGT event happen, which is J5, if the two years expires and you haven't acquired a replacement asset. But at that time, the individual shareholder will be 55 years old. And that changes things, especially in relation to the retirement exemption.

So we trigger J5, the 15-year exemption can't apply, we can't utilise small business rollover, because we've already used it. However, it makes no reference to the use of the retirement exemption on a J5 event. So therefore we could apply the retirement exemption, and the EM, going back to 2009, sort of confirms this. And you can make payments to the CGT concession stakeholder and there would be no requirement to roll over that retirement exemption amount into super, because at this point in time, the individual's over 55. Also by deferring that gain, could be useful if you're anticipating some capital losses arising, in which case that capital gain could absorb that capital loss that arises in that two year period.

So again, not applicable in all cases, but something to think about. And then also just be aware there are some J2 events. Not going to worry too much about what these actually are. We've talked about J5 being where you don't, or you fail to, acquire a replacement asset. J6 is where you have one, but the amount you've spent is not enough to cover the gain that's been rolled over under the replacement rollover. So it's just the shortfall, is the game that arises.

The thing to look out for is if you're inheriting a new client and the client is carrying forward one of these potential J events. So when you're taking on a new client, look at their structure. Very important to ask the question whether the small business replacement rollover has been applied. Very important to get that, because if you don't ask that question, chances are the J5 or the J6, for example, gets triggered after you've taken them on as a client, you miss that, and then the ATO come and do a review.

So not a good look for anyone, but just be aware of something to ask for when you're taking on a new client. And that's all I have for you today, so Alison, I'll hand over to you to run through those questions. Thank you.

CCH Learning:

Thank you very much, Carlo. Okay, so as mentioned, there are a few questions that have come through, and we will run through those shortly in a Q&A. In the interim, I will quickly mention our upcoming webinars. So we're looking at Couples, Care and Considerations in terms of aged care, Income Tax Case Update, Non-commercial Loss Rules, also The Ins and Outs of Super, FBT session on entertainment, and Tax Implications of Business Structures. So jump on the CCH Learning website if you're after the details of those webinars.

All right, first question from Edward. So if a client puts a current company into liquidation, is he allowed to start a new business under a new company later?

Carlo Di Loreto:

Yeah, yeah, absolutely. So just to be clear, what I'm talking about here is, we're selling business assets out of the company, so it's a genuine sale to an arm's length buyer. No problem. And then starting a new business, you can either use the same company, but I think to be prudent, I'd probably... Sorry, in a liquidation, you can't use the same company. Sorry, you'd just be getting a clean skin. But yeah, no problem with that. But this case study assumes it's just a sale to an unrelated party. Everything's at arm's length, liquidate the company, go out, get a new one, start a new business.

The thing, Edward, you do need to take into account, and it's not something that we've covered in today's presentation, but we'll probably touch on in the June presentation when we look at commercial aspects of a business or share sale, is the terms of the agreement. Now, many agreements will have or could have restrictive covenants in place, which may prohibit even the shareholder... even though the company's being liquidated, but it often applies to shareholders as well as the entity that sells a business. So not a tax issue, but definitely a legal issue and one to discuss with the lawyers. But at the very least, you'd have to go back to the business sale agreement and be very aware of any limitations that the agreement might set out. So good question Edward, thanks for that.

CCH Learning:

Thank you Carlo. Amanda's asked, if the client doesn't sell the business but winds down the business, is it better to liquidate the company or pay dividends?

Carlo Di Loreto:

Look, that's also a very good question. If you're just winding down the business, as you can see in our situation here, first things first, you got to work out, well what small business relief measures could possibly apply? Because in our case, what gives rise to that advantage is the way that you can get the active asset reduction out in a liquidation. Now, if you're just winding down a business, you're not going to be triggering any gains.

So what I'd be looking at is your franking account, I'd be looking at capital. If there's any minimal capital, then I would say there's not going to be much of an advantage between liquidating or paying out as dividends. But also, look at the equity section of the company's accounts to see, had there been gains made in the past, especially pre-CGT capital reserves? Now, if you've got those, then yeah, you may want to liquidate, because you can get those out quite effectively if, for example, the shareholders are pre shareholders.

So very tricky question, that one, and it just really depends on the circumstances, but they're the sorts of things you'd want to weigh up, but you do need to analyse the situation thoroughly to make that decision. But really good question, thanks.

CCH Learning:

Thank you, Carlos. Sam has asked, how much would a liquidator cost in the example on slide 17?

Carlo Di Loreto:

Yeah, look, this is a really good question, Sam. This is a really simplified scenario, but a typical small business company, you're probably going to spend, I would say close to 10,000. But once the client sees the advantage of liquidating overpaying dividends, 10 grand is not much to pay.

And the other thing which is really important is there's another advantage to liquidation which again is not tax related, but is commercial and legal. And that is, once you formally liquidate a company, so that's going to be, in our case, the liquidation of a solvent company, right? And what we call that is a members' voluntary. The formality of going through a liquidation in that case is it buries a company once and for all.

If you pay things out as dividends and then strike off the company, you're always open to someone coming along, making a claim, and then going to ASIC seeking to re-register the company. If you go through a liquidation process, the chances of that happening reduce significantly. So that's another really good commercial and legal reason to go through a formal liquidation. And I think for that kind of cost, it's money well spent in my book. So hopefully that answers your question. Thank you.

CCH Learning:

Thank you, Carlo. Mark has said, other than capital gains, what other issues need to be considered when looking to restructure shareholdings in an entity to facilitate the SI test being achievable? I.e. dealing with the existence of different classes or shares. Would dividends access shares? Which would compromise the [inaudible 01:03:48] test being met?

Carlo Di Loreto:

Yeah, no, you're right. It's not just CGT, but what you need to have a look at is the value of these shares. So hypothetically, you could argue that a dividend access share has no value, in which case it would be perhaps a relatively simple matter to just cancel those shares. But that's very simplistic, okay? When we're cancelling shares, we've got things like value shifting. There's a whole lot of anti-avoidance rules that need to be held in place. Much more difficult when you've got things like preference shares in place and different voting rights.

So yeah, it's very legalistic. So when you've got different classes of shares, there's usually going to be shareholder agreements in place. And what's in those shareholder agreements, I'm telling you, is the variability is unlimited. It's whatever shareholders agree to. So it can be very legalistic. But in the simplest scenario, if it was just dividend access shares, it should be possible to just cancel them. Because in all the situations I've seen, those shares really would have no value to an outsider because there's no obligation by the directors to pay a dividend on those shares. Typically, they are completely discretionary, they have no voting, they have no capital rights, and just an expectancy if that.

In other words, it's not that different to being a discretionary income beneficiary of a discretionary trust. So I think the short answer? Legal. And that is look at shareholder agreements, look at the different types of shares and specifically the rights attached to those, and be very careful if there are preference shares in there, variability and voting rights and what have you. May not be so easy to fix those. Hopefully that gives you some idea, but I'd certainly be reviewing the shareholder agreements and the constitution of the company to see what the consequences would be. So thank you for that.

CCH Learning:

Thank you Carlo. And lucky last from Amanda, the client has sold business A and continues to operate business B, both under the same company. Can they withdraw the 50% asset reduction cash? If so, would that be better paid as dividend? Or any better suggestion to withdraw that 50% asset reduction cash from the company?

Carlo Di Loreto:

Yeah, no, I think you're kind of stuck. If you've got a company that you're continuing on, you have very limited options to get that active asset reduction component out of the company, because you're essentially just limited to dividends.

Now, what I've seen some advisors do, depending on the structure you've got, is interpose a new holding company and then use that as a dividend trap and then pay the dividend up if it's fully franked. The other way is to maybe put a holding company in there and consolidate, and then you can pass the cash up. But very complicated. Consolidation doesn't always work, because you've got to do your ACA, which may not work out. You may not have franking credit, so if you don't consolidate, even when you're passing up to a new holding company, you may have top-up tax to pay. So very limited options there.

But if you have to keep the company, then liquidation is not possible, and that benefit that we talked about in the case study only arises in a liquidation scenario. So very limited options there. I'd probably just look at drip feeding that out as dividends, to the extent of franking credits over a long period of time, and hopefully you've got some shareholders in there who are on relatively low marginal tax rates that can probably take advantage of that. But your options there, yeah, there's not many, not much you can do in that scenario. So thanks for that question.

CCH Learning:

Thank you very much, Carlo. All right, that is all the questions that have come through for today, so appreciate you covering those and appreciate the audience sending them through as well.

So in terms of next steps, there is a feedback survey. Please take a moment to let us know your opinions, and shortly after the session today, you will receive an email letting you know when the recording is ready. You'll also have access to a verbatim transcript, your CBD certificate, and of course this PowerPoint presentation.

So thanks again to Carlo for the session 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 Loreto:

Thanks, Alison.