

ACQUISITION AND DISPOSAL OF BUSINESSES

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INTRODUCTION

The acquisition or disposal of a business is a complex process. Due diligence is required to clearly identify exactly what is being acquired or sold. This involves the gathering and documentation of large amounts of information. It is important that this information be accurate and up to date, as false or misleading information could provide grounds for rescinding a sale or damages being sought. Confidentiality is also likely to be very important. However, in addition, it is very important for consideration to be given to financial issues and structural arrangements, and for the parties avoid problems that could arise due to poor planning in relation to the transaction.

The acquirer of a business may do so by acquiring the assets of the business – including tangible assets and intangibles such as goodwill – or acquiring the business itself, including shares in the company if the business is a company.

The best approach is to acquire only the assets, because acquiring the shares in a company means that the acquirer also inherits any commercial, legal, tax and other liabilities of the company, be they known or unknown. Share acquisition is to be avoided unless the purchaser is consciously seeking to utilise the company's unrecouped losses (see tax issues below)

The points I will focus on in this presentation are:

1. Tax and Accounting issues;
2. Due diligence and Early planning issues;
3. Structures involved; and
4. Tips to minimise pitfalls.

1. TAX AND ACCOUNTING ISSUES

The acquisition and disposal of businesses can raise significant revenue considerations.

Important issues arise from:

- (a) ordinary income tax;

- (b) capital gains tax (CGT);
- (c) stamp duty; and
- (d) goods and services tax (GST).

In general, it should be noted that (i) various elements of a transaction may have different tax implications for the vendor and the purchaser, and (ii) the *Income Tax Assessment Acts* contain anti-avoidance provisions that can be used to negate a tax benefit derived from an arrangement entered into with the dominant purpose of obtaining that tax benefit.

Ordinary Income Tax

Income tax provisions pertaining to trading stock or property may arise.

Capital Gains Tax (CGT)

CGT assets include not only land and buildings, shares, units in a unit trust, collectibles etc but also legal or equitable rights such as contractual rights and goodwill.

If a CGT event involves a contract, the time of the event is usually when the contract is entered into, not when it is completed.

Some CGT events of particular relevance to the acquisition or disposal of a business are:

- A1 - disposal of a post-19 September 1985 CGT asset
- B1 – where use and enjoyment of a post-19 September 1985 CGT asset passes before title
- C1 – loss or destruction of a post-19 September 1985 CGT asset
- C2 – ownership of a post-19 September 1985 intangible CGT asset ending by redemption, release, discharge, expiry or surrender etc (eg expiry of a lease or option)
- D1 – creation of a contractual or other right in another entity (eg restrictive covenant or right to use a covenant)
- D2 – granting an option
- F1 – granting a lease
- G1 – capital payment for post-CGT shares
- H1 – forfeiture of a deposit
- H2 – receipt for an event relating to a CGT asset
- K6 – sale of pre-CGT shares in a company or interest in a trust

- K8 – direct value shifts

The amounts received from a CGT event are generally called the capital proceeds.

Some issues to be aware of include:

- (a) where the taxpayer is an individual, a superannuation fund, a trust or a life insurance company, the capital gain may be discounted if the CGT event happens after 12 September 1999 and the asset has been owned for at least 12 months;
- (b) if the CGT event is a "supply" for GST purposes, the GST on the supply is excluded when working out the capital proceeds; and
- (c) there are special rules that apply to personal use assets and collectables, such as art works.

Care should be taken in determining the entity which should acquire a business, as different tax considerations apply to companies and trust compared with individuals. If a company or trust is used to acquire a business, care should be taken so that the structure facilitates taking advantage of potential CGT small business concessions (Note: there is a maximum net asset value limit of \$5 million).

Another point of note is that, if the purchaser prefers to pay by instalments, this will not be in the vendor's interest from the tax point of view as, for CGT purposes, the consideration is treated as having been derived by the vendor at the time of the disposal.

If shares in the company are sold and there is a change of 50% or more in the beneficial ownership, continuity of ownership will be failed and therefore pre-CGT assets will be converted to post-CGT assets, and accumulated tax losses and bad debts will not be available to be recouped unless the company satisfies the "same business" test. If a purchaser of shares strips the company and sells the shares at a loss, dividend stripping provisions apply, including anti-avoidance provisions.

Parties should be aware that the Australian Taxation Office is always on the look out for elaborate arrangements that seek to avoid or reduce capital gains tax in connection with the acquisitions or disposal of businesses, especially where such arrangements use convoluted transactions that lead to income re-characterisation and conversion through intra-group asset transfers and dealings, converting an accounting profit from an asset sale to a much-reduced capital gain, or even a capital loss, for tax purposes.

Stamp Duty

Stamp duty provisions differ in each State.

Queensland, South Australia, Tasmania, Northern Territory and ACT impose duties on the transfer of a business. New South Wales and Western Australia impose duty on particular

assets transferred in the sale of a business. Victoria imposes duty only on transfers of interests in real property in Victoria.

Goodwill, restrictive covenants, licences, assignment of contracts, debts, leased equipment and even intellectual property, in certain circumstances, could also be dutiable.

It is therefore important to provide details of what is being transferred in order to calculate the applicable duty.

Goods and Services Tax (GST)

GST of 10% may apply where a business is sold by a vendor that is GST registered. The purchaser may subsequently claim back the GST as an input tax credit if they are GST registered.

Thus the ultimate effect for a "going concern" is that the transaction is GST-neutral. To simplify matters, the transaction is considered to be "GST-free". One of the conditions to be met is that the parties agree that the business is a "going concern", but this is not of itself sufficient to meet the exemption requirements. The vendor must undertake to carry on the conduct of the business as a going concern until the completion of the sale, and must supply all things necessary for the continuation of the enterprise. Sale of an existing franchise may qualify as a going concern.

The going concern exemption is not relevant when a company is sold by disposing of its shares. The sale of shares is a financial supply under the GST Law. Accordingly, the Seller does not pay GST on the proceeds of the share sale, and the vendor and purchaser will not normally be able to claim input tax credits on relevant acquisitions. However, the transaction may involve other supplies (apart from the sale and purchase of shares) that may be subject to GST (eg a restraint of trade, payments under indemnities etc).

2. DUE DILIGENCE AND EARLY PLANNING ISSUES

Legal due diligence for the acquisition of a business will cover the following areas:

(a) **Vendor's capacity to sell**

Review of constituent documents of the vendor (including title, constitution and trust deeds).

(b) **Charges**

Identify and review all mortgages, charges and other encumbrances over the assets of the Business – hopefully the acquisition will be free of encumbrances.

(c) **Assets**

Review location and description of owned plant and equipment.

Review all lease and hire purchase agreements relating to plant and equipment and motor vehicles (including capital and operating leases).

Ensure they can be assigned.

(d) **Regulatory matters**

Review all governmental licences, permits, certificates, registrations and exemptions for the operation of the Business.

(e) **Real property, including planning and environmental issues**

Conduct relevant searches and review title documents relating to all freehold property of the Business.

Review all the particulars and leases relating to leasehold property of the Business including term, rent and rent review provisions.

Review all licences to occupy land.

Review zoning and development consents.

(f) **Employees and industrial relations**

Review terms of employment of all employees, termination arrangements, long service and annual leave entitlements, loans, compliance with awards and union arrangements, safety/workers compensation, bonus plans, relevant unions/industrial relations.

Sick leave entitlements are sometimes a trap.

(g) **Superannuation**

Review trust deeds, explanatory booklets and all relevant documentation concerning superannuation arrangements for the employees of the Business.

(h) **Intellectual property**

Conduct searches and review registration of all patents, designs and applications, registered and unregistered trade marks, business names and copyright (including software) owned or used by the Business.

Review all agreements, licences and particulars of all arrangements relating to intellectual property.

(i) Contracts

Review:

- (i) customer lists, customer contracts and supplier agreements;
- (ii) agency sales, commission and distribution agreements;
- (iii) agreements relating to material acquisitions or disposals of assets;
- (iv) standard conditions of sale; and
- (v) agreements entered into outside the ordinary course of business.

Report on term, consideration, notice, assignability, penalties, change of control provisions and other material terms of the above.

Consider trade practices issues arising out of the agreements.

(j) Litigation

Review details of all claims, litigation, arbitration and governmental proceedings or disputes made, pending or threatened against the Business, as they may be relevant to an assessment of the Business and its products.

(k) Insurances

Review all insurance policies, details of outstanding claims, certificates of currency and brokers' renewal reports.

(l) Trade debtors and receivables**(m) Liabilities** (current, non-current, actual or contingent)**Early Planning**

As a vendor, you should be prepared to address all these issues, and more. Therefore, when a decision is made to sell a business, early planning and preparation of documentation will assist. Preparation for sale generally also requires gathering information about financial status and past profitability.

Guarantee

The purchaser might additionally seek guarantees from the directors or principal shareholders in a company in respect of performance of all the vendor's obligations under the contract or in respect to the accuracy and fulfilment of warranties and representations. Without such guarantees, the purchaser's remedies are generally confined to the vendor company, which may have insufficient assets. It is a matter for negotiation whether the purchaser's obligations under

the contract should also be guaranteed, or whether the deposit of up to 10% should be regarded as sufficient.

Warranties

The vendor should warrant that any specific warranties contained in the agreement are accurate and complete, contain no material omission and are not misleading, and that if the vendor becomes aware prior to completion of any facts which render any of the warranties incorrect, inaccurate, false or misleading, the vendor will disclose the facts to the purchaser prior to completion. Warranties are often capped by time and amount, and apportion the risks associated with the transaction. They can encourage the vendor or Directors to sort out any problems in the company before signing the contract.

Representations

Similarly, vendors should only make representations that are factual and truthful. It is not prudent to make promises or forecasts about the future. If the representation preceded the contract and acted as an inducement, there are remedies under the general law for fraudulent, innocent or negligent misrepresentation. Statutory remedies for misrepresentations also now apply under the *Trade Practices Act (1974)* (Cth) and the State Fair Trading Acts (eg *Fair Trading Act 1987* (NSW)).

Indemnities

A worried purchaser might seek a specific indemnity on issues of concern, such as a tax liability, whereby the vendor will reimburse the purchaser if a specific loss or liability arises.

3. TIPS TO MINIMISE PITFALLS

Major differences arise

Sometimes major differences arise or one party gets "cold feet" in the course of the negotiations.

One way to avoid this problem and prevent it from terminating the discussions is to first enter into a Heads of Agreement.

A Heads of Agreement identifies principal elements of a transaction and records agreement in principle, thereby assisting the development of the formal agreement and also initiating investigative processes. It flushes out major differences and provides a platform for confidentiality and exclusivity undertakings, and also assists the identification of important commercial terms. It does, however, add another layer to the negotiations and might constrain future negotiations.

Pre-completion practice

Under the general law, the sale of the goodwill of the business as a going concern imposes some obligation on the vendor to conduct the business properly between exchange of contract and completion. However, this may not be sufficient to ensure a smooth handing over of the business as a going concern to the purchaser.

Specific terms in the contract relating to stock, advertising and employees, as well as restrictions on other changes to the way in which the business is conducted pending completion, can assist in the delivery of the business functioning as anticipated by the purchaser. Also tuition of the purchaser just prior or immediately after completion, and familiarisation with customers, suppliers and employees can assist.

Employees

Employees are a key part of the assets of a business.

On transmission of a business, annual leave, sick leave and long service leave all need to be considered to determine employees' entitlement and hence the liabilities to be taken into account in the purchase price.

It is important to arrange for the transfer of employment arrangements and account for the aforementioned leave liabilities, but not terminate employees, as this can lead to increased costs to the purchaser. One approach is for the vendor to state in the contract that the same benefits and entitlements should apply to the workers transferring to the new employer and that their continuity of service should be recognised. This should protect the outgoing employer from redundancy claims. The onus is then upon the purchaser/ new employer to honour this commitment.

Additional issues need to be noted under the new Industrial Relations reforms. WorkChoices has introduced changes to the transmission of business rules, such that a new employer will be bound by the award or collective agreement applying to transferring employees for a period of twelve months and must agree in writing to accept liability for accrued entitlements. In addition, transferring employees must be given notice of the new awards that will apply after that date, and the seller must give the buyer particular information such as details of employees on parental leave.

From the purchaser's perspective, it might also be important to include a statement in the contract to the effect that specified key workers, or a certain number of workers, must transfer across to the new employer. If this does not occur, the viability of the business could be undermined.

Sale of shares or assets

If there is a choice between sale of shares or sale of assets, the vendor should be aware that, unless there are significant tax losses, it is highly unlikely that a share sale would be

advantageous to a purchaser – it is more likely that a purchaser would be interested in an asset sale. The primary reason for this is that a purchaser of shares will inherit all the liabilities, the most significant of which is a general tax liability.

Whilst this can be protected by way of a warranty, which is generally limited to a percentage of purchase price for a period of time which is usually one year (the usual exception is that a tax warranty runs for six years), it is generally not sufficient comfort to overcome the advantage of an asset sale to the purchaser.

Pre-conditions to completion

Any regulatory pre-conditions, such as Foreign Investment Review Board (FIRB) approval or Australian Competition and Consumer Commission (ACCC) approval of mergers or acquisitions, should be identified from the outset.

Relevant approvals from the corporation's Board, or a lessee, or in relation to any key licences or finance providers should also be identified early in the discussions so that they can be adequately investigated prior to the signing of any contractual commitments.

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