TAX TALKS

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42 | Legal Issues When Buying or Selling a Business

Legal issues when buying or selling a business can cost buyers and vendors a lot of time and money. Most of the common pitfalls are not rocket science. In fact they are often easy to navigate around. But just as easy to forget and overlook.

Legal Issues When Buying or Selling a Business

Here are the most obvious legal issues to consider when buying or selling a business. Vendors risk losing the small business CGT concessions. Buyers risk receiving more than they bargained for. They are small things easy to get right, but just as easy to get wrong or forget.

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Vendor’s Involvement Post-Sale

For the 15-year exemption, the taxpayer must have sold the business “in connection with an individual’s retirement”. The business owner must retire or have become permanently incapacitated.

So when the vendor doesn’t retire, but stays on to help the new owner find their feet, they may run the risk of NOT qualifying for the 15-year exemption all together. And hence may end up receiving a huge capital gains tax bill. So make sure that the contract doesn’t include a lengthy transition period.

Guidance from the ATO is scant on this topic. The only guideline is in their Advanced Guide, where the ATO states that there has to be a significant reduction in the number of hours worked. The guide uses the example of a business owner going from 60 to 35 hours and states that this is not sufficient to be counted as retirement. However, mentoring the new owner for a few hours a week is ok….. What about in between? Maybe.

How to avoid this issue? Retire altogether and make it a clean cut. Or just mentor for a few hours a week for a separate hourly fee.

Share v Asset Sale

If the business is in the hands of a sole trader or a partnership of individuals, you can skip this one. The sale will always be an asset sale. But if the business is run in a company, you have the option of a share or asset sale.

Vendors usually prefer a share sale. Only a share sale will allow applying the 50% Div 115 discount. An asset sale wouldn’t since companies don’t qualify for the Div 115 discount. And a share sale gets rid of liabilities and contingent liabilities. Getting rid of all the skeletons in the closet.

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Purchasers usually prefer asset sales for exactly that reason. An asset sale avoids contingent liabilities ever rearing their head. No skeletons in the closet. And the cost base is easy to work out. However, all this might change due to commercial ramifications.

Commercial Ramifications

Sometimes it is these commercial ramifications that dictate the structure of a sale.

Let's take a real estate agency with a rental role as an example. A sale of business assets, including the rental roll, triggers the need to assign these rent roll contracts to the new owner. For any clients objecting to this assignment, the rent roll contracts come to an end at the time of the asset sale. These terminated contracts will reduce the amount of management fees, which the buyer would have paid for. Even with an earnout arrangement in place this scenario will probably still be disadvantageous to the buyer, so the purchaser is likely to request a share sale as well.

Some specific business licences can't be transferred to another person or entity and hence need to stay with the entity. Also requiring a share sale.

Restructure Before Sale

Sometimes it is possible to restructure the business in a way that will give the purchaser the desired asset sale while the vendor still gets their share sale. But this option will become harder in light of the proposed reforms. And might run into Div IVA issues.

Timing

Timing is crucial for many aspects of the sale, but most of all the small business CGT concessions.

One of the reasons that timing is so important is that the minimum net asset value test is done just before the CGT event. Sometimes vendors still need to divest assets or contribute money to super to get below the $6m MNAV test. If the timing is wrong, the CGT event might come too early.

The CGT event happens at contract date – date of exchange. The date when both parties commit to the arrangement.

Heads of Agreement

A Heads of Agreement may turn into the binding contract that unintentionally triggers the CGT event. If this is the case, the vendor might lose the opportunity to tax plan for the MNAV test. So it is important to avoid signing a Heads of Agreement too early.

An example where this happened is *Confidential V FCT* [2013] AATA 76. The parties entered into a Heads of Agreement and then four months later a formal sale.

Their Heads of Agreement stated, "The vendor agrees to sell to the purchaser and the Purchaser agrees to purchase from the Vendor, the Vendor's interest in the ….. business described in the First Schedule below on the terms and conditions set out in such schedule." The first schedule contained essential terms of agreement and a clause stating that the parties would as soon as practicable enter into a formal contract.

This Heads of Agreement was ruled to be the contract that triggered the CGT event, thwarting the vendors efforts to qualify for the MNAV test.

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So make sure that the Heads of Agreement is drafted so it is not a legally binding contract. Better still do not sign one at all, make no agreements otherwise and just sign the later formal sales contract, when ready and safe to do so.

However, exactly the opposite might be the issue. The vendor might need the CGT event to happen in the current income year to qualify for the concessions. In that case, make sure the agreement is legally binding as of 30 June.

Contributions to Super

Ensure that deadlines are met to deposit monies into super. That they are met to preserve the “small business CGT concession” status of the contribution. If payments are made and documents are submitted in time, then the contribution does NOT count towards the non-concessional contributions cap.

Guarantors

Remember to release guarantors, for example under leases or loans, as part of the sale. The guarantees might have been given many years ago and completely forgotten. Once the sale is complete, it can be difficult for the vendor to get out of these guarantees.

Related party loans

This is especially important for a share sale. Purchasers prefer a “clean-up” before sale.

Clean up of Division 7A loans and UPEs required to make sure that the 80% active asset test can be achieved. For this, excess cash should be paid out as a dividend. There are often structuring opportunities available around this issue.

PPSR

Make sure personal property security interests are released and that this release is recorded in the Personal Property Securities Register (PPSR). Otherwise the buyer might receive an encumbered assets not realising that there is a charge on the asset.

Restraints

When advising the buyer, make sure any restraints are reasonable and can’t be void. When advising the vendor, make sure the restraints still allow the vendor to do what they want to do after the sale.

Excluded Assets

Be clear on the assets that are excluded from the sale. This often leads to misunderstandings and fights over minor assets with sentimental value.

And Also

Review contracts for “deemed” assignments or triggers.
Consider debt forgiveness. The debt forgiveness rules might play a role.
Consider tax consequences when exiting a tax consolidated group.

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There is a lot more to consider, but this is an overview of the most common legal issues when buying or selling a business for buyers and vendors to consider.

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Div 7A Debt Forgiveness

Improving the Small Business CGT Concessions ED

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