Business Purchase Tax Checklist

In the process of buying a business, the purchaser should conduct a due diligence review to establish that they are buying what they believe they are buying. The review identifies areas of risk and contingent liabilities that the business may have and to factor these risks in the purchase price.

When buying a business, or the company that conducts a business, there are many tax issues that the purchaser needs to consider prior to the contract being signed.

In most cases a purchaser acquires the assets of the business unless there are significant commercial reasons for buying the company (e.g. contractual obligations that cannot be assigned). Purchasing the assets of the business nullifies the risk of assuming the company's liabilities, some of which may not be known or readily identifiable.

The taxation implications of buying either the assets of the business or the shares in the company are very complex and professional advice should be obtained.

In particular, it is worth noting that for reasons such as the 50% Capital Gains Tax (CGT) discount and accessing the small business CGT concessions the vendor will often have a preference for selling the shares rather than the business assets, and the structure of the sale will often become a major point of negotiation, balancing commercial factors such as risk against the vendor's tax implications.

SUMMARY CHECKLIST- Asset and Share Purchases

Buying assets of the business

1. Income

1.1 Sale of goods
1.2 Services income
1.3 Royalties
1.4 Rent, e.g. sub-leases
1.5 Other
1.6 Unearned income

Review whether the basis on which income is returned is correctly accruals or cash basis. Ensure allowance is made for unearned income received.

2. Tax deductions

2.1 Review seller's tax position to ensure that business expenses will be tax-deductible
2.2 Review the tax implications of unusual expense items

3. Trading stock

3.1 Purchase price and book values allocations
Ensure correct tax basis is used, full cost, market value or replacement value
3.2 Purchaser and seller tax treatment
Ensure the seller will use the same tax basis as the purchaser
Review company tax exposure for a share purchase

4. Trade debtors

4.1 Appropriate treatment of trade debtors

5. Accrued employee leave

5.1 Are employee leave adjustments provided for?
5.2 Vendor to pay accrued leave?

5.3 Purchase price to be adjusted for leave payments?

6. Depreciable assets - plant and equipment

6.1 Tax depreciable asset schedule reviewed for qualifying plant and equipment items
6.2 Review depreciation rates for tax compliance

7. Business premises

7.1 Obtain building expenditure tax notice
7.2 Review details, including depreciable items
7.3 Leases, consider the lease assignment

8. Work-in-progress

8.1 Review the sale basis adopted
8.2 Review the deductibility to the purchaser

9. Goodwill and statutory licences

9.1 Review tax treatment of goodwill and licences
9.2 Review possible future application of the CGT small business entity tax concessions

10. Other intangible assets

10.1 Review other intangible assets for depreciable items
10.2 Review other intangible assets for capital tax treatment

11. Goods and services tax

11.1 Review GST treatment of the sale for GST-free status
11.2 Review the application of the GST margin scheme
11.3 Review GST cash or accruals basis, including the implications of other relevant entities
11.4 Review correct GST accounting for input tax credits, GST-free sales and input taxed sales

12. Business tax structure

12.1 Review tax structure required for business asset purchase
12.2 Review income allocations and CGT implications
12.3 Review holding entities for shareholding and unit holding purchases

13. Other taxes

Buying shares in the company

1. Tax status

2. Trading stock

3. Capital Gains Tax (CGT)

4. Tax losses

4.1 Review tax loss implications for asset purchases
4.2 Review tax loss implications for share and unit trust purchases

5. Other taxes

5.1 Review other tax obligations, e.g. GST and PAYG withholding obligations
5.2 Review payroll tax implications

5.3 Review WorkCover obligations
5.4 Review superannuation guarantee (SG) implications
5.5 Retained earnings & franking credits

BUYING ASSETS OF THE BUSINESS

The type of assets usually purchased include trading stock, goodwill, plant & equipment, business premises, trademarks and other intangible assets. Depending on the circumstances, other assets may be acquired and liabilities may also be assumed.

The price paid for the business should be allocated between all the business assets being acquired and the values separately allocated in the contract.

The ATO will generally accept the allocation of sale proceeds between the various classes of assets as agreed in the contract provided the vendor and the purchaser are dealing at arm's length.

In addition, the tax treatment of the business income should be reviewed to ensure that business income has been correctly returned by the seller and will be correctly returned by the purchaser in order to avoid any misunderstanding by the vendor.

1. Income

For both the purchase of a business and the purchase of shares in a business the purchaser should review the tax treatment of income of the business to ensure that the correct basis is adopted so that annual tax liabilities are properly calculated so as not to leave open a question of an unfavourable review by the taxation office.

In the review of income, consideration should be made as to whether the basis on which income is returned is correctly accruals or cash basis.

An allowance should also be made for any unearned income received by the business and consider future tax adjustments on the unearned income.

2. Tax deductions

Review that expenses to be claimed in respect of the business will be tax-deductible and that the various domestic and foreign tax rules have been complied with.

Identify items that are not tax deductible, and any items eligible for other write-offs, e.g. under the blackhole provisions in section 40-880.

3. Trading stock

The valuation of trading stock can have a material effect on the sale negotiations. The purchaser prefers a higher value allocated to stock as this results in a higher cost of goods sold and therefore a lower profit, whereas the vendor prefers a lower value to reduce their assessable income.

For tax purposes the vendor is treated as selling the stock for its market value and the purchaser is treated as having bought the stock for this value.

4. Trade debtors

The purchaser doesn't normally acquire the trade debtors of the business as a tax deduction is not allowed for any debts that subsequently go bad. Instead the purchaser should collect the debts as agent for the vendor.

5. Accrued employee leave entitlements

Where the purchaser will retain some of the employees, it is important that accrued employee entitlements (e.g. annual leave and long service leave) are determined and factored in the purchase price.

There are three alternative ways of dealing with accrued employee entitlements upon the purchase of a business:

1. If the relevant employee's Award or Workplace Agreement does not provide for the employee's leave entitlements to be transferred to the purchaser, the **vendor can pay out these liabilities** and obtain a tax deduction.
2. The **vendor makes a payment to the purchaser** who in turn takes over the employee's accrued leave entitlements. The purchaser either assumes these liabilities because it is a legal requirement, or because the purchaser has agreed to do so. The vendor may be entitled to a deduction for the accrued leave transfer payment and the purchaser is assessable on the amount received.
3. The **purchase price is reduced** in recognition of the purchaser accepting responsibility for the accrued leave entitlements. The reduction in the sale price is generally not deductible to the vendor nor is it assessable to the purchaser.

6. Depreciable assets-plant and equipment

A value should be allocated to all the items of depreciable assets (plant & equipment and all other tax depreciable assets). The purchaser would prefer to allocate a greater amount to plant & equipment as either depreciation or an outright deduction can be claimed for each individual item.

In relation to tax depreciable assets, it is also worthwhile considering the implications of the small and medium business instant asset write off threshold, currently $150,000 until 31 December 2020.. If the prior business owner had fully written off some assets for tax purposes then the purchaser will be unable to claim any tax deduction for these. Furthermore for assets that are written down and subsequently sold at a price above the written down tax value, there could be tax payable on an upward balancing adjustment.

7. Business premises

Where the purchaser is also acquiring the business premises, a tax deduction for the capital costs of building works, including any structural improvements carried out, usually passes to the purchaser.

The purchaser should ensure that that a notice is provided by the vendor outlining the construction cost details for the purposes of claiming the building write-off. The substantiation of the claim could also include a report by a Quantity Surveyor, which may have previously been obtained by the vendor but if insufficient substantiation exists then the purchaser might subsequently commission their own report once the sale has been completed.

Where the business premises are leased, it is important that you understand your legal rights and obligations as lessee, assignee or lessor when it comes to commercial leases. Depending on the lease agreement, there could be some additional disclosure requirements or restrictions on assigning a lease.

8. Work in progress

An amount paid by the purchaser to the vendor for work in progress (WIP) is generally assessable to the vendor and tax deductible to the purchaser. When the WIP has been completed it will be assessable to the purchaser either:

- When the amount becomes a recoverable debt, if the purchaser is operating on an accruals basis: or

- When the amount is collected by the purchaser, if operating on a cash basis.

9. Goodwill & statutory licences

The purchase of business goodwill and also statutory licences (e.g. liquor licence, taxi licence, fishing licence) is a capital asset and is subject to CGT upon ultimate disposal. Therefore no tax deduction is available to the purchaser.

The purchaser may in turn be entitled to claim the small business CGT concessions upon a future disposal of goodwill and statutory licences.

10. Other intangible assets

A licence relating to the use of a copyright, patent or registered design is an intangible depreciating asset and the purchaser is entitled to a deduction over its effective life. The Tax Act[1] prescribes an effective life for certain intangible depreciating assets as follows:

Standard patent	20 years
Innovation patent	8 years
Petty patent	6 years
Registered design	15 years
Copyright	The shorter of
(Except copyright in a film)	- 25 years, or
	- The period until the copyright ends
In-house software	5 years

11. Goods and services tax

GST will normally apply when purchasing a business unless the supply is GST-free. This commonly occurs when the going concern exemption is applied and reflected in the contract of sale.

The GST going concern exemption may also apply where the purchaser is acquiring all the items necessary for operation of the business, including the business premises.

12. Business tax structure

The purchaser will need to consult their accountant to determine the most appropriate structure for operating the business. This could either be a company, unit trust, family trust, partnership or as a sole trader.

Where the purchaser is also acquiring the business premises, it is preferable for asset protection purposes to purchase the premises in a separate entity.

The future application of the small business CGT concessions need to be considered before deciding on the appropriate structure.

What should also be considered is the application of the small business restructure rollover which will allow taxpayers to roll over active assets into another entity without triggering any income tax liabilities. Please note this is only available in circumstances where the ultimate economic ownership of the assets does not change hands.

13. Other taxes

If the business is purchased through an earnout arrangement then the capital gains tax treatment will need to be considered for both the seller and purchaser.

[1] Income Tax Assessment Act 1997 s.40-95(7)

If the rights are treated as look-through earnout rights then any capital gains or losses are initially disregarded, instead the capital gains and losses for the seller, and the associated application of CGT concessions, are considered at the time when payment is made.

Any financial benefit provided by the purchaser will be added to the cost base of the underlying asset and any financial benefit received by the seller will be added to the capital proceeds from the sale of the underlying asset. This is a complex area, and appropriate advice should be sought.

BUYING SHARES IN THE COMPANY

It is assumed that the purchaser is buying shares in a single wholly owned Australian Pty Ltd company that operates a business in Australia.

There are usually no GST implications to the purchaser or buyer upon the transfer of shares as this is constitutes an exempt financial supply.

A number of additional taxation issues need to be considered when buying the shares in a company as the purchaser is automatically assuming any current outstanding and contingent liabilities of the company.

Where issues are identified, the risks can be mitigated by using the income tax consolidation provisions, with appropriate post-sale restructuring, although this would involve some additional costs that should be factored into the negotiations with the vendor.

Some of the issues to consider include:

1. Tax status

Under the system of self-assessment, the company's income tax returns will not have been reviewed in any detail by the Australian Taxation Office (ATO) unless the company has been the subject of a tax audit or review. Some of the items that require detailed examination include:

- Review tax returns for the past four years and supporting work papers, including detailed reconciliations of profit/loss as per the financial statements and taxable income/loss. Confirm that the tax returns have been lodged.
- Enquire as to whether the company is currently, or has ever been, a subsidiary member or head company of a tax consolidated group. If so, this may raise a number of other tax and commercial questions to be addressed.
- Review certain potentially contentious expenses claimed for the past four years to confirm deductibility (e.g. repairs & maintenance, legal fees, interest paid, domestic and overseas travelling and entertainment).
- Request a copy of the ATO Integrated Tax Account from the company's tax agent to confirm that all tax obligations are up-to-date.
- Review copies of Fringe Benefits Tax (FBT) returns and supporting work papers for the past four years. Confirm that all FBT returns have been lodged and that fringe benefits tax has been correctly classified and calculated.
- Review copies of company franking accounts for the past four years, including details of dividends paid and the extent of franking. Check whether there is any liability for franking additional tax, franking deficit tax, or deficit deferral tax
- Note there have been changes in legislation to company tax rates, and the purchaser should ensure the correct franking rate is being used on dividends paid.
- Review copies of both accounting and tax fixed asset registers and related fixed asset reconciliation schedules for those years. This may include confirmation that purchase price, cost of improvements, existence, and written down value of the assets can be verified.
- Review any bad debt deductions claimed for tax purposes over the last four years to ensure that the debts were genuinely bad and written off prior to the end of the relevant income year.
- Where the company is carrying forward revenue or tax losses from prior years, assess the continued availability of the various parcels of losses as discussed in section 4 below

- Assess whether any transactions may not have been undertaken on arm's length (market value) basis between related parties.
- Determine whether any debts owed by or to the company have been forgiven in the past four years, and if so, what tax adjustments or capital loss claims resulted.
- Where there are loans to shareholders or their associates, check that interest and principal repayments have been correctly calculated and that a properly executed loan agreement is in place.
- Review copies of any correspondence with the Tax Office for the past four years to identify if there are any disputes including:
  - all private ruling requests, requests for the Commissioner's opinion or objections lodged, and all responses received;
  - requests for an amended assessment; and
  - requests for information from the Tax Office, whether as part of a formal audit or otherwise and all responses provided. Otherwise confirm that the company has no knowledge of any intended audit activity.
- Review copies of internal and external advice to identify any aggressive tax positions taken in tax returns for the past four years and determine potential tax shortfall penalties.

2. Trading stock

Confirm that trading stock has not been overvalued by the company in its tax returns for the past four years. If so, there may be a substantial hidden tax liability going back for many years and this will also impact on the value of the company.

3. CGT

- If acquiring a controlling interest in the company, no adjustment should be made to the purchase price for any assets acquired prior to the introduction of CGT on 20 September 1985. This is because the Tax Act deems all of the pre-CGT assets to have been acquired at their market value on the date the shares in the company are purchased. Consider obtaining a formal valuation of the relevant assets to substantiate the commencing cost base for CGT purposes.
- The current market value of any substantial post 19 September 1985 assets needs to be determined so that the purchaser can take into account and adjust the purchase price for the future CGT liability that will arise when the assets are eventually sold.
- Determine whether there have been any capital gains tax rollovers to the company since 20 September 1985. Obtain details of the assets involved, their cost base and potential market value at the time of transfer.
- If acquiring a minority interest in the company, the purchaser needs to consider the possible application of the small business CGT concessions upon future sale of the shares. One of the conditions for claiming the small business CGT concessions is that the individual must hold at least a 20% shareholding (directly or via interposed entities such as trusts) to be a CGT concession stakeholder.
- When testing this, ensure that a review has been conducted of the different classes of shares on issue (if more then one) and their respective rights to dividends, voting and capital returns. Of particular concern is the existence of any "discretionary dividend shares" that can have the effect of treating no shareholder as having a fixed entitlement to 20% of the dividends that may be paid, and that in turn may rule them out of claiming any of the small business CGT concessions on a subsequent share sale.
- Another important condition is that the shares qualify as an "active asset", meaning that at least 80% of the total value of the company's assets is represented by active business assets (including goodwill and other intangibles). Often the active asset test will apply going forward, i.e. for years where the purchaser owned shares, but there are some instances where the "active asset percentage' during the vendor's ownership period can become relevant, and this should be raised.
- If the shares quality as an "active asset" then consideration should be given to the possibility of utilising the small business restructure rollover.
- When considering small business CGT concessions, the additional eligibility conditions since February 2018, including some modified tests that also need to be satisfied. These amendments to legislation make it harder for businesses with investments in larger entities

to access the concessions. These changes also impact businesses with multiple owners due to a broadening of the grouping rules.

4. Tax losses

If the company has income tax or capital losses, obtain a schedule of these losses and review details of losses utilised during the past five years to ensure that the company has satisfied either the “continuity of ownership” or the “same business” test from the start of the loss year through to the end of the income year.

Obtain details of any changes in share ownership of the company since incorporation to assist in this review.

If acquiring a controlling interest (i.e. 50% or more), the losses can only be carried forward against future profits if the company continues to satisfy the “similar business test”. This means that there must be a level of identity between the company’s business activities before the time of the change of ownership and the company’s business activities during the income year in which the deduction is claimed.

When negotiating the purchase price for the company, do not allow for the future benefit of the tax losses unless it is certain that the company will obtain those benefits.

5. Other taxes

5.1 GST & PAYG withholding obligations

- Review GST returns for all periods from 1 July 2000, including summary sheets, schedules and other documents used in the preparation of the BAS returns.
- Enquire as to whether the company is currently, or has ever been, a member of a GST Group. If so, this may raise a number of other tax and commercial questions to be addressed.
- Obtain and review copies of all accounts from the Tax Office (e.g. income tax and integrated client account). .
- Review copies of any Recipient Created Tax Invoice agreements, sample copies of invoices and adjustment notes issued by the company.
- Confirm that all BAS’s have been lodged for the period since 1 July 2000 and payments have been correctly made for GST and PAYG.
- Review the status of independent contractors to ensure they are properly classified. There could be hidden liabilities for PAYG withholding, superannuation guarantee contributions, Workcover and payroll tax where the contactors are working under normal employee conditions.
- If PAYG withholding amounts are unpaid before the due date, the Commission of Taxation may issue a director penalty notice which will be equal the unpaid liabilities.

5.2 Payroll tax

- Determine whether payroll tax returns have been lodged and payroll tax paid in each jurisdiction.
- Determine whether the payroll tax threshold has been met and thus whether payroll tax still applies.
- Consider whether the entity is appropriately grouped or not grouped with other entities for payroll tax purposes (including entities based in other States/Territories).
- Assess whether the amount of salary and wages shown in the accounts approximates the amount declared for payroll tax.
- Review the status of independent contractors to ensure they are properly classified, including whether they meet the definition of a deemed employee or any required exemption applications have been lodged with and approved by the relevant State/Territory revenue offices.
- Determine whether single touch payroll (STP) applies and ensure the necessary reporting requirements have been met.
- Determine whether there are any outstanding assessments or refund claims.

5.3 WorkCover

- Review copies of WorkCover premiums for the past three years.
- Review WorkCover correspondence to determine whether there are any documents advising of WorkCover premium rates or industry classifications, outstanding claims or claims history.
- Determine whether WorkCover premiums and payments are up to date.
- Review the status of independent contractors to ensure they are properly classified.
- Assess whether there are any outstanding obligations, assessments or challenges currently undertaken in relation to WorkCover.

5.4 Superannuation guarantee

- Review copies of all superannuation guarantee payments for the most recent financial years.
- Review the status of independent contractors to ensure they are properly classified.
- Determine whether all superannuation guarantee payments have been made and whether they have been made in time.
- Determine whether there have been any shortfall penalties in the past four years.
- If superannuation guarantees charges are unpaid before the due date, the commission of taxation may issue a director penalty notice which will be equal the unpaid liabilities.

5.5 Retained Earnings and Franking Credits

- Ordinarily when buying a company, it is likely that the retained earnings balance may be reduced to NIL by the vendor before sale. This could also reduce the company's franking credit balance before the sale, so keep this in mind.
- The franking credits that remain in the company at the time of the sale can be utilised by the new owners.