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Topical Tax issues relating to Mergers & Acquisitions

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Part I: Income Tax

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This paper summarises a number of topical income tax issues relating to mergers and acquisitions. The following matters are addressed in detail below:

- Recent developments in capital gains tax (CGT) rollovers – demerger and scrip-for-scrip rollovers
- Taxation treatment of earn out arrangements
- Topical issues with tax indemnities and warranties
- Topical issues with tax consolidation.

Recent developments in CGT rollovers – demerger and scrip-for-scrip rollover

Introduction

The application of demerger CGT rollover relief has been highlighted in a number of recent high profile transactions. Interesting issues arise particularly where demerger relief is sought to be obtained in conjunction with other CGT rollovers (particular CGT scrip-for-scrip rollover).

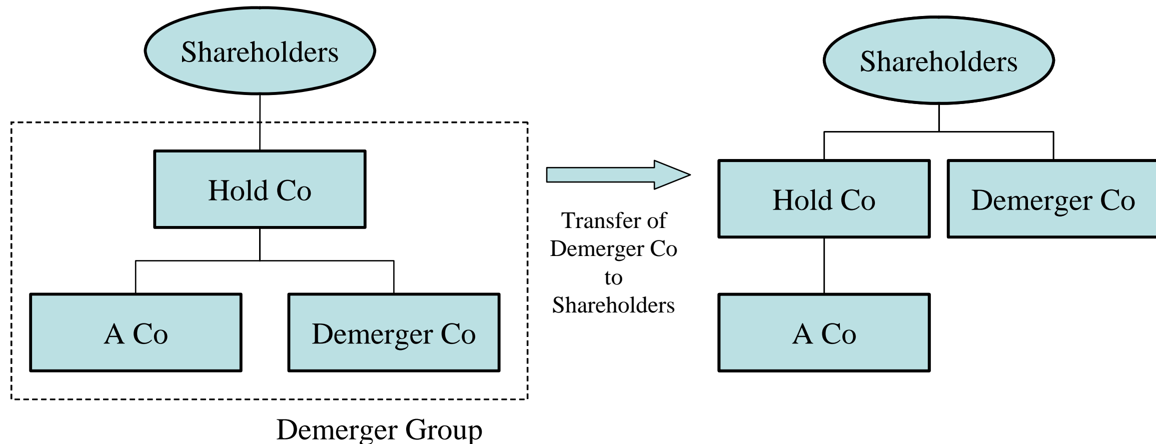
Set out below is a refresher regarding the basic conditions for the application of CGT demerger and scrip-for-scrip rollover. A number of recent transactions are then analysed to illustrate some of the issues that can arise in M&A transactions.

The basics - demerger CGT rollover

The demerger CGT rollover rules are set out in Division 125 of Part 3-3 of the 1997 Act. The demerger rules apply to companies and trusts. The summary below focuses on companies only. The key provision is section 125-55 which states that a taxpayer can choose to obtain a rollover if:

- the taxpayer owns an interest in a company (original interest);
- the company is the head entity of a demerger group;
- a demerger happens to the demerger group; and
- under the demerger, a CGT event happens to the original interest and a new or replacement interest is acquired in the demerged entity.

The essence of a demerger transaction is summarised in the diagram below.



Under this simple demerger transaction, Hold Co disposes of the shares that are held in Demerged Co to its shareholders. After the transaction, shareholders in Hold Co continue to hold their shares in Hold Co but now also hold shares directly in Demerged Co.

A key issue in obtain CGT rollover is whether the arrangements constitute a "demerger" as defined in section 125-70. In summary, all of the following conditions must be satisfied (referring to the entities in the above diagram):

- There must be a “restructuring”.
- Hold Co must dispose of at least 80% of its interests in Demerged Co to shareholders (or issue/issue and cancellation such that shareholders hold at least 80% of Demerged Co).
- Under the restructuring, a CGT event happens to a shareholder in respect of the shares in Hold Co and the shareholder acquires a new interest in Demerged Co and nothing else or no CGT event happens to a shareholder in respect of the shares in Hold Co and the shareholder acquires shares in Demerged Co and nothing else.
- Shareholders of Hold Co acquire shares in Demerged Co only because they hold shares in Hold Co.
- The new interests acquired must be shares in a company (ie Demerged Co).
- Certain requirements regarding the proportionality and the value of the shares that are acquired in Demerged Co must be satisfied. In summary:
  - each shareholder of Hold Co must acquire the same proportion (or as nearly as practicable the same proportion) of shares in Demerged Co as are held in Hold Co; and
  - just after the demerger, the value of a shareholder's interest in Hold Co and Demerged Co must have the same proportionate market value as the shareholder's shares in Hold Co had prior to the demerger.

The most significant points are:

- there must be a restructuring;
- a Hold Co shareholder must not receive anything other than shares in Demerged Co under the demerger; and
- Hold Co must dispose of no less than 80% of its interests in Demerged Co to Hold Co shareholders under the restructuring.

The consequences of a valid tax demerger include:

- generally, the transfer of Demerged Co to shareholders is tax free (although "de-consolidation" issues need to be reviewed);
- the receipt of shares in Demerged Co is tax free to shareholders (the transfer of shares in Demerged Co will be either a capital reduction or in specie dividend);
- not subject to CGT;
- no income tax or (for non-residents) withholding tax on the dividend element; and
- broadly, shareholders allocate their original CGT cost base in the shares in Hold Co over shares in Hold Co and Demerger Co on a “reasonable” basis (having regard to respective values).

It is also necessary to consider the application of the integrity measures in section 45B of the 1936 Act (schemes to provide capital benefits and demerger benefits). Section 45B specifically applies to a demerger. In summary, section 45B applies where:

- a person is entitled to a “demerger benefit” (defined broadly to include the provision or increase in value of ownership interests in a company); and
- having regard to the “relevant circumstances”, it would be concluded that a person who entered into the scheme did so for a purpose (other than an incidental purpose) of enabling a taxpayer to obtain a tax benefit.

If section 45B is applicable, the Commissioner of Taxation can make a determination that all or part of the "demerger benefit" will not be treated as an exempt demerger dividend in the hands of the shareholder.

The "relevant circumstances" for the purposes of section 45B where the scheme involves the disposal of ownership interests include:

- the period the ownership interests were held; and
- when the arrangements for the disposal were entered into.

In relation to the application of section 45B to demergers, the ATO has issued a practice statement (PS LA 2005/21). The following comments are relevant:

> "The section guards against the use or structuring of a demerger to accommodate a substantial purpose of delivering a tax benefit to a relevant taxpayer (generally the shareholders of the head entity). Broadly, the mischief that mobilises section 45B is the use of a demerger to deliver

> value from company to shareholder in a tax preferred form (whether as a 'demerger dividend' or as capital in substitution for a dividend) as an end in itself and not merely as the natural incident of a business restructure of the demerger group" (from PS LA 2005/21)

PS LA involves a concept of a "**genuine demerger**" – being a transaction that is aimed at restructuring a business in the interests of business efficiency. The paramount purpose is the restructure of a business rather than, for example, achieving a tax effective sale of the interests in Demerged Co.

In terms of the purpose test in section 45B, PS LA 2005/21 states:

> "It is expected that most, if not all, schemes of demerger will have a purpose of enabling taxpayers (that is, the head entity's shareholders) to obtain a tax benefit. Whether it constitutes a more than incidental purpose of the scheme is a matter to be determined objectively from the relevant circumstances of the scheme. If the business or commercial purpose for the scheme is not sufficiently cogent, it is likely that the tax purpose will be more than incidental. But if the tax purpose merely follows the commercial purpose as its natural incident, the tax purpose will be incidental."

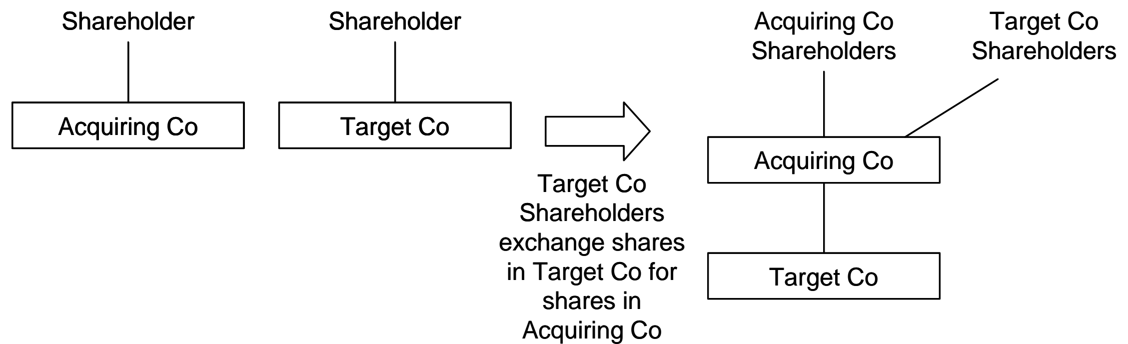
Clearly transactions that involve a sale of the interests in the demerged entity shortly after the demerger will be closely scrutinised both in terms of whether the transaction constitutes a genuine "demerger" for tax purposes and whether section 45B is applicable. Section 45B is capable of extremely broad application and effectively gives the Commissioner a wide discretion to effectively deny the application of demerger relief in relevant circumstances.

Finally, the general anti-avoidance measures in Part IVA of the 1936 Act are generally relevant to a tax benefit that arises in connection with a scheme that can be identified as part of the demerger transaction.

The basics – scrip-for-scrip CGT rollover

The scrip-for-scrip CGT rollover rules are set out in Subdivision 124-M of Part 3-3 of the 1997 Act. The rules are applicable to companies and trusts but this paper deals with companies only.

The essence of a scrip-for-scrip transaction is summarized in the diagram below:



In summary, the key requirements are as follows:

- A shareholder in a company exchanges a share in the company for a share in another company.
- An option (or similar) in a company is exchanged for a similar interest in another company.
- The exchange is the consequence of a single arrangement that:
  - results in Acquiring Co (or a wholly-owned group that includes Acquiring Co) holding at least 80% of the shares in Target Co;
  - be one in which at least all owners of voting shares in Target Co can participate; and
  - be one in which participation was available on substantially the same terms for the owners of interests of a particular type in Target Co.
- The shares in Target Co are post-CGT shares.
- Apart from the rollover, a shareholder in Target Co would make a capital gain from a CGT event happening to its shares.
- Shareholders in Target Co choose to obtain CGT rollover.

Other rollover conditions are also applicable if the shareholders in the Target Co and the acquiring entity are not dealing at arm's length and either the entities did not have at least 300 members or are members of the same "linked group". The additional conditions broadly relate to the replacement shares having a similar value and carrying the same kind of rights and obligations as the original shares.

If scrip-for-scrip CGT rollover applies, the CGT event that takes place in respect of the shares in Target Co is disregarded.

Some recent demerger transactions

Set out below is a discussion regarding some recent demerger transactions. The following transactions all general consist of a demerger followed by a sale (often using CGT scrip-for scrip rollover). The following transactions are discussed below:

- Progressive Enterprises Holdings Ltd from Foodland (2005)
- Healthscope from Symbion (**revised** 2007 proposal recently abandoned)
- Consolidated Media Holdings (PBL) from Crown (2007).

Progressive Enterprises Holdings Ltd (PEH) from Foodland Australia Limited (FAL) (2005)

- This transaction involved a demerger CGT rollover followed by a sale of the demerged entity (using a scrip-for-scrip CGT rollover). The transaction is the subject of a Class Ruling (CR 2005/74).
- From the ATO Class Ruling (CR 2005/74):

  "Arrangement is part of a proposal announced by FAL on 25 May 2005. The proposal involves the acquisition of FAL's Australian business assets (excluding Woolworths Action Shares) by Metcash and the acquisition of FAL's New Zealand business assets and Australian Woolworths Action Shares by WOW.

  The acquisitions will occur through the implementation of two schemes of arrangement; the Demerger Scheme and the Transfer Scheme."

- Steps:

  In summary, the transaction involved a "demerger scheme" followed by a "transfer scheme":

Demerger scheme

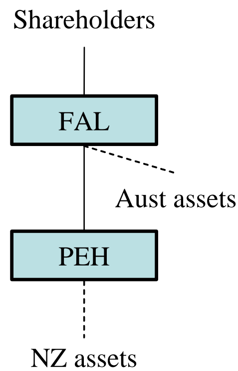
1. FAL incorporates PEH (a new company)
2. Transfer of FAL's NZ business assets to PEH
3. Demerger of PEH shares (transferred to shareholders of FAL)

Transfer Schemes

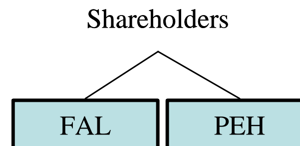
Scrip-for-scrip acquisition of:

1. Shares in PEH by Woolworths
2. Shares in FAL by Metcash

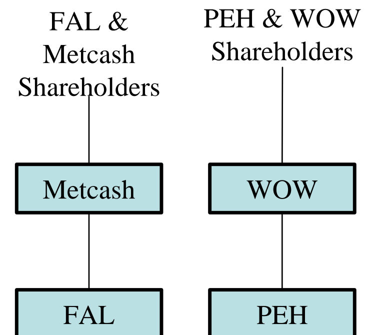
Steps 1 & 2 Incorporation of PEH and NZ asset transfer



Step 3 Demerger of PEH



Step 4 Transfer Schemes



- The Transfer Schemes were conditional upon the Demerger Scheme being approved by FAL shareholders, but the Demerger Scheme was not conditional upon the approval of the Transfer Schemes
- Class Ruling CR 2005/74 confirmed:
  - Demerger CGT rollover applied and the demerger of PEH was therefore tax free.
  - Section 45B did not apply:

    > "It is plain from the commercial circumstances of the demerger that it is being undertaken to restructure the company's business and that the capital and profit components of the demerger allocation are consistent with those commercial circumstances. It is also apparent that there is nothing in the other relevant circumstances of the demerger, including the company's distribution history or the known circumstances of the shareholders, to suggest that the favourable tax outcome of the demerger for the shareholders is anything more than the natural incident of the business restructure."

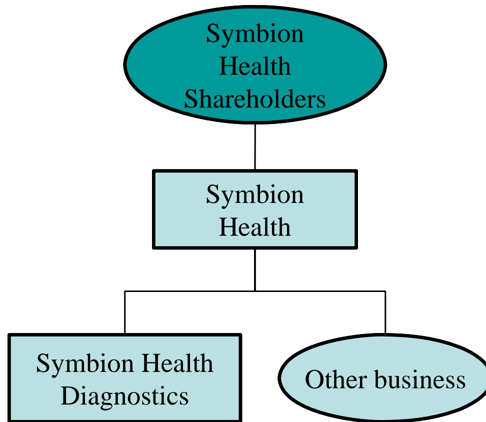
  - CGT scrip-for-scrip rollover applied to the Transfer Schemes.
- CR 2005/74 is interesting in that it appears to permit a demerger followed by a transfer of the demerged entity in a pre-ordained transaction. Whether such an approach would still be taken today is an interesting question.

Healthscope *revised* proposal (2007)

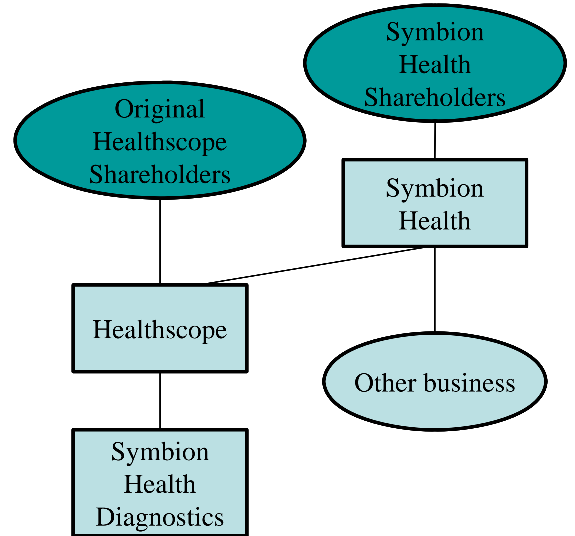
- This transaction was complex but for present purposes sought to rely on CGT demerger rollover followed by CGT scrip for scrip rollover. The transaction ultimately did not proceed following an unfavourable taxation ruling.
- A simplified version of the relevant steps involved the following:
  - Symbion Health held 100% of the shares in Symbion Health Diagnostics;
  - Healthscope acquired Symbion Health Diagnostics under a scrip-for-scrip transaction (involved the issue of Healthscope shares to Symbion Health)

- Demerger of Healthscope shares by Symbion Health to Symbion Shareholders
- IAC consortium acquires Symbion Health for cash.

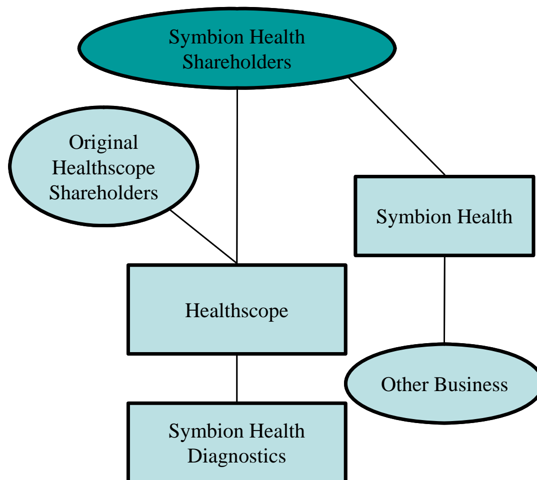
1. Start



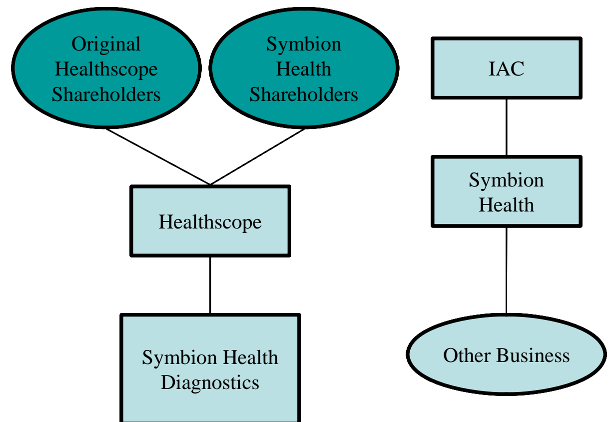
2. Healthscope acquires Symbion Health Diagnostics (issues shares to Symbion Health)



3. Demerger of Healthscope Shares



4. Sale of Symbion Health to IAC



- The ATO refused to give ruling confirming CGT rollover. The indication from press releases issued at the time suggest that the problem was scrip-for-scrip rollover. It is unclear whether any issues arose with respect to CGT demerger relief.
- The inference from the public materials regarding the proposed transaction is that CGT scrip-for-scrip rollover followed by a CGT demerger rollover appears to have been a problem.

PBL and Crown (2007)

- This transaction was complex but for present purposes sought to rely on CGT scrip-for-scrip rollover followed by CGT demerger rollover. The transaction is the subject of a Class Ruling (CR 2007/111).

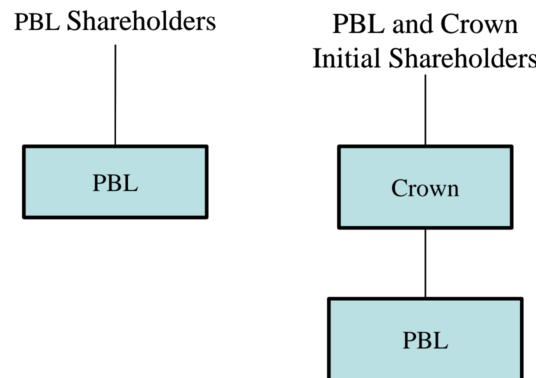
Steps

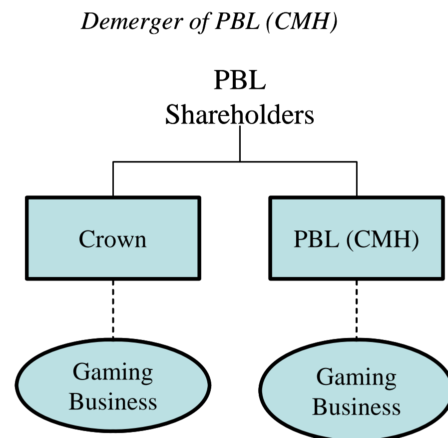
The transaction was complex but a simplified version of the key steps is set out below:

- **PBL Scheme**: Crown (a new company) acquired shares in PBL for cash and scrip (partial CGT scrip for scrip rollover applied).
- **Demerger Scheme**:
  - Reorganisation of gaming and media assets such that gaming businesses are held by a Crown subsidiary and media businesses held by PBL.
  - PBL (renamed CMH) is demerged from Crown and transferred to shareholders.

1. PBL scheme

2. Demerger scheme





(Crown acquires PBL for cash/scrip. Scrip for scrip CGT rollover applies to scrip component)

In summary, based on Class Ruling CR 2007/11:

- CGT scrip-for-scrip rollover applies to scrip component of PBL Scheme.
- No CGT demerger rollover relief for Demerger Scheme.
- CR 2007/11 ruling simply states the transaction was not a "demerger" within the meaning of the 1997 Act:

  "**Demerger relief not available**

  40. The Demerger Scheme is not a demerger within the meaning of that term in section 125-70 of the ITAA 1997. Therefore, the CGT and

> dividend consequences and relief described in Subdivision 125-B of the ITAA 1997 and subsections 44(3) and (4) of the ITAA 1936 will not apply to the participating PBL shareholders."

- No explanation is provided and it is unclear why the ATO reached that position. The strong view of the relevant advisers was that the transaction was a demerger for tax purposes and it appears to fall within the technical requirements of Division 125.
- Without demerger, tax relief issues potentially arose for PBL shareholders on the distribution of PBL shares.
- The tax issues for Crown in respect of the demerger of the PBL shares were presumably assisted by the application of the tax consolidation rules. Crown and PBL elected to form a tax consolidated group following the PBL Scheme. The tax consolidation rules potentially allow the tax basis of the assets held by PBL to be reset through the allocable cost amount push down process (therefore limiting the tax consequences to Crown on the transfer of the shares in PBL to the Shareholders). Refer to the discussion of Recent Press Releases which adversely impact this push down below.

Recent Press Releases

The interaction of CGT rollovers and the tax consolidation "reset" of the tax value of assets through the allocable cost amount "push down" process has been the subject of a number of recent announcements.

In October 2007, the (former) Assistant Treasurer made an announcement regarding proposed changes that impacted that application of the tax consolidation rules (and particularly the ability to obtain an uplift for the tax values of assets under the tax consolidation rules through the push down process).

The original announcement stated that the proposed transactions were generally applicable to entities joining a tax consolidated group after 12 October 2007 (but subsequently extended to 16 October 2007 for transactions announced by listed companies (ie such as the PBL transaction referred to above)).

In summary, the proposed changes indicated that where the target is acquired using a scrip for scrip rollover, the acquiring company cannot reset (ie uplift) the tax basis of the assets of the target under the tax consolidation measures. The proposed changes were also stated to be applicable to other CGT rollovers.

On demergers, the October 2007 announcement stated:

> "the measures will not apply to demergers unless that demerger happens as part of the arrangement that involves an entity joining a consolidated or MEC group"

A further announcement regarding these measures was made on 10 January 2008 by the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs. The January 2008 announcement indicated that the proposed changes would be subject

to further consultation. The announcement states that the consultation will focus "*on ensuring non-contrived commercial takeovers involving an exchange of scrip are not affected by the changes*".

Consultation is continuing and it will be interesting to see how the concept of "non-contrived" commercial transactions is incorporated into legislative measures that impact the reset of the tax values of assets under the consolidation rules.

Taxation treatment of earn out arrangements

General

On 17 October 2007, the ATO released draft Taxation Ruling TR 2007/D10 regarding the CGT consequences of earn out arrangements.

TR 2007/D10 covers two types of earn out arrangements:

- A "standard earn out" arrangement is any transaction where an income producing asset is sold for consideration that includes a right to future payments that are contingent on the economic performance of the asset (eg. a business is sold for $10m plus $1m if earnings exceed a given level); and
- A "reverse earn out" arrangement where an income producing asset is sold for a nominated sum but the seller agrees to make payments to the buyer after the sale based on the earnings of the asset post sale (eg. a business is sold for $10m but the seller must repay $1m if the earnings do not exceed a given level).

The treatment proposed in TR2007/D10 is complex. An earlier taxation ruling (TR 93/15) dealing with standard earn out arrangements was withdrawn when TR 2007/D10 was issued. There are some significant changes between TR 2007/D10 and TR 93/15.

In summary the approach taken in TR 2007/D10 is to treat the earn out right as a separate asset (rather than adopting a "look through" approach where payments in respect of the earn are treated as simply adjusting the consideration for the sale.

TR 2007/D10 is yet to be finalized and consultation is continuing.

The taxation treatment in respect of earn out arrangements is summarised below.

Standard earn out (ie Seller receives $X plus $Y if earn out conditions are met)

For the Seller:

- Capital proceeds equals $X cash plus earn out right.
- Earn out right is not money or a right to receive money.
- Market value of the earn out right needs to be worked out at date of CGT event.

- CGT event C2 happens when earn out right comes to an end. A capital gain/capital loss will arise based on comparison between payment(s) in respect of earn out (ie capital proceeds) and the CGT cost base of the earn out.

For the Buyer:

- Cost base in asset consists of $X plus market value of earn out right;
- CGT event D1 does not happen on creation of the earn out right because buyer is considered to be "borrowing money or obtaining credit".
- No CGT consequences in respect of subsequent payment(s) under earn out because the Buyer is not disposing of, or acquiring a CGT asset. No impact on CGT cost base in asset if, for example, earn out payments are less than the market value of the earn out rights (the draft ruling is silent on this point).

Reverse earn out (ie. Seller receives $X and must pay back $Y to buyer if earn out conditions are not met)

For the Seller

- Capital proceeds for the asset include $Y but do not include market value of the earn out right, ie. effectively, part of the cash proceeds received by the seller are attributable to the grant of the earn out right and are excluded from the CGT proceeds for the sale of the asset.
- Cost base of the earn out right is the sale proceeds that are reasonably attributable to the creation of the right.
- CGT event D1 does not happen on creation of the earn out right (as above).
- Payment by Seller under the earn out:
  - does not reduce Seller's original capital proceeds in respect of the asset;
  - does not give rise to a capital gain or capital loss for the Seller.

For Buyer

- The buyer has acquired the assets consisting of the underlying asset and the reverse earn out right.
- The cost base of the earn out right is that part of consideration that is attributable to the right.
- CGT event C2 happens when the earn out right comes to an end. A capital gain/capital loss will arise based on a comparison between the payments in respect of earn out (ie capital proceeds) and the CGT cost base of earn out.

Example – standard earn out

Assume the following regarding a standard earn out arrangement:

- A owns 100% of the shares in X Co with a CGT cost base of $10m.

- A agrees to sell the shares in X Co to B for a cash payment of $15m plus an additional earn out payment if the earnings of X Co in the year following the sale exceeds $5m. The earn out payment is the amount by which the earnings exceed $5m up to a maximum of $1m.
- At the date of the sale agreement, the earn out right has a "market value" of $0.6m.
- A year later, the earnings of X Co are determined to have been $6m and a further payment of $1m is made.

For A (Seller)

Shares – capital proceeds	$15m cash
	$0.6m value of earn out right
	$15.6m
Less CGT cost base for the shares	($10m)
Capital gain on shares	$5.6m
Earn out right – capital proceeds	$1m
Less CGT cost based for earn out right	($0.6m)
Capital gain	$0.4m

For B (Buyer)

- CGT cost base for X Co Shares:

Cash paid	$15m
Value of earn out right	$0.6m
Total CGT cost base	$15.6m

- Earn out right – no consequences (?)

The simple example above illustrates a number of inconsistencies and issues:

- For the Seller, the total consideration received in respect of the assets consisting of the shares and the earn out right will equal the total amount paid by the buyer.
- However, the capital gain that arises on the earn out right is treated separately and has a separate characterisation to the underlying asset. For example, if the underlying asset is a pre-CGT asset, the earn out right will not be treated as a pre-CGT asset. Also, the CGT discount will not be available if the earn out right is held for less than one year (even if the CGT discount is applicable to the underlying asset).
- A mismatch will arise for a seller if, say, a capital gain arises on the sale of the underlying asset but a capital loss arises on the termination of the earn out right in a subsequent year (the two cannot be offset).
- The draft ruling is silent on the treatment to the buyer in the event that the payment under the earn out is different to the market value of the earn out right. In the above example, B pays $16m but only gets a CGT cost base in the assets of $15.6m. The

ruling does not address what happens to the $0.4m (it would appear to be difficult to claim a deduction for this amount as "black hole" expenditure). In the reverse scenario, where the market value of the earn out right exceeds the payments under the earn out right, the buyer appears to retain its CGT cost base in the asset (this may be a particular advantage where the tax basis of assets is reset by reference (in part) to the Buyer's CGT cost base in the shares under the tax consolidation rules).

- The draft ruling provides limited meaning of guidance on the manner in which the earn out right should be valued. Given the different consequences that arise to buyers and sellers query whether the parties are able to adopt different valuations of the earn out right.
- Query whether the approach adopted is applicable in respect of indemnities and warranties. Traditionally, sale agreements would be drafted on the basis that a payment under an indemnity or warranty was a reduction in CGT the consideration for the asset. Does the "separate asset approach" require indemnities and warranties to be accounted separately?

Example – reverse earn out

Assume now that the arrangement involves:

- A owns 100% of the shares in X Co with a CGT cost base of $10m.
- A agrees to sell the shares in X Co to B for a cash payment of $15m. If the earnings of X Co in the year following the sale do not exceed $5m, A agrees to pay to B the amount by which the earnings are less than $5m (subject to a maximum payment of $1m).
- At the date of the sale agreement, the earn out right has a market value of $0.6m.
- A year later, the earnings of X Co are determined to be $4.7m and A pays $0.3m to B pursuant to the reverse earn out.

For A (Seller)

• Shares – capital proceeds	$15m cash
Less CGT cost base for the shares	($10m)
Capital gain on shares	$5m
• Earn out right – no consequences (?)	

For B (Buyer)

• CGT cost base on X Co shares	
Cash paid	$15m
Value of earn out right	$0.3m
Total CGT cost base of both shares and earn out right	$15.3m
• Capital proceeds for earn out right	$0.3m
Cost base of earn out right	($0.6m)

Capital loss	$0.3m

Topical issues with tax indemnities and warranties

Review periods

The time periods for amending assessments were changed as part of amending legislation following on from the Review of the Self Assessment system (ROSA).

A key change is that a nil assessment (ie where there is no taxable income or tax payable) is treated as an "assessment" for the 2004/05 and subsequent years. Complex transitional periods apply for years prior to the 2004/05 year.

Previously, a year where there was no taxable income or tax payable (e.g. a loss year) was not treated as an assessment that started running the period in which an amendment could be made. The result was that such returns were previously open to amendment at any time.

For relevant years, the above changes are likely to mean that limitation periods of four years are more likely to be accepted for tax warranties and indemnities. However, the four year period does not apply in a number of circumstances including:

- fraud or evasion;
- transfer pricing and R&D adjustments; and
- other taxes (such as stamp duty, payroll tax etc).

Tax consolidation

The tax consolidation measures and particularly the potential joint and several liability of subsidiary members of a group for group income tax liabilities continues to be a focus of income tax indemnities and warranties. Key ongoing issues include:

Given that the tax consolidation regime has been in place since 2002, we are seeing entities that have been members of various tax consolidation groups. This raises issues in terms of determining the potential for income tax liabilities of various consolidated groups, and drafting appropriate indemnities.

CGT event L5 which can cause a tax liability to the head company of a group on the deconsolidation of a subsidiary continues to be a focus in transactions that involve a deconsolidation of one or more subsidiaries.

The changes to the amendment periods referred to above generally make it easier for a subsidiary to make a "clean exit" from a tax consolidated group, at least in respect of years after 2004/05. However, the ability of subsidiaries to make a "clean exit" in respect of group income tax liabilities remains a complex area. One issue is whether a subsidiary remains exposed to tax liabilities in respect of amendments that take place after the subsidiary exits a tax consolidated group but that which relate to periods when it was a member of the group. The ROSA amendments referred to above make it

easier for a subsidiary to make a clean exit (at least for the 2004/5 income year and following) but difficulties can still arise.

Topical issues with tax consolidation

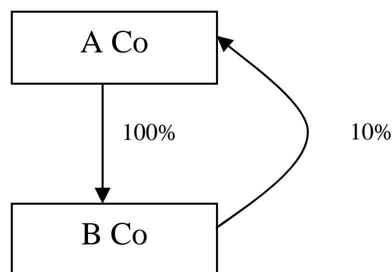
Treatment of intra-group assets

The tax consolidation measures continue to create unresolved issues for M&A transactions in a number of contexts.

One issue that has arisen in a number of recent transactions is the treatment of "cross" shareholders in takeovers or merger transactions and the application of the "single entity rule" in section 701-1 of the 1997 Act.

The issue can be summarised simply as follows:

Assume that A Co proposes to take over B Co but that B Co holds 10% of the shares in A Co. Assume that the takeover is successful and A Co acquires 100% of B Co but B Co continues to hold the shares in A Co.



The Corporations Act requires B Co to divest the shares in A Co within 12 months of A Co gaining control of B Co.

If B Co becomes a member of the A Co tax consolidated group, the issue is how the following mechanisms to deal with the elimination of cross shareholding are treated under the tax consolidation rules:

- A Co buys back the shares held by B Co;
- The shares held by B Co are cancelled; or
- The shares held by B Co are transferred to a third party.

The single entity rule (SER) is set out in section 701-1 of the 1997 Act and provides that for the purposes of determining the taxable income of the A Co consolidated group, the subsidiaries of the group are treated as part of A Co rather than as separate entities for income tax purposes.

Under the SER, B Co is effectively deemed to be a member of A Co rather than a stand alone entity.

When B Co joins the A Co consolidated group, the tax basis of B's assets are broadly reset by the allocable cost amount (ACA) "push down" process.

Charges were introduced to the tax consolidation rules in 2004 to deal with so called "intra-group assets". In summary, in determining the assets that have their tax basis reset, section 701-10 refers to each asset of the entity joining the group assuming that the SER did not apply. The result is an express requirement to reset the tax basis of intra-group assets (such as the shares held by B in A). This is an intended result to ensure that any intra-group assets take an appropriate share of the ACA as part of the push down process.

Section 701-58 of the 1997 Act was also inserted in 2004 to deal with "intra-group" assets and is as follows:

> "Section 701-58 Effect of setting the tax cost of an asset that the head company does not hold under the single entity rule
>
> (1) This section applies if:
>
> (a) the tax cost of an asset was set at the time (the joining time) an entity became a subsidiary member of a consolidated group, at the asset's tax cost setting amount; and
>
> (b) ignoring the operation of subsection 701-1(1) (the single entity rule), the entity held the asset at the joining time; and
>
> (c) taking into account the operation of subsection 701-1(1) (the single entity rule), the head company of the group did not hold the asset at the joining time.
>
> Example:
>
> A debt owed by a member of the group to the joining entity at the joining time.
>
> (2) To avoid doubt, the asset's tax cost setting amount mentioned in paragraph (1)(a) is not to be taken into account in applying the provisions mentioned in subsections 701-55(2), (3), (4), (5) and (6) in relation to the asset at and after the joining time."

The intention appears to be that although the tax basis of an intra-group asset is reset as part of the initial ACA push down process, that reset cost base is then disregarded for the purposes of section 701-55 (2) to (6) (which states how the reset cost base is determined). This is presumably on the basis that the asset is no longer relevant due to the application of the SER.

The above rules operate acceptably for say, an intra-group debt owed by a subsidiary to a head company. Intra-group equity is more problematic. Particular difficulties arise where the intra-group equity is subsequently divested. In the above example, the shares held by B Co in A Co need to be divested within 12 months. The issue is, assuming a buy back , share cancellation or share sale is implemented, how are the tax consequences determined given the application of the SER and section 701-58 referred to above.

Part II: GST

Sale of Assets

The sale of a business's assets is subject to the same GST rules as any other supply. Consequently, the sale of assets such as a business's plant and equipment, stock-in-trade, intellectual property, land, goodwill, work in progress and statutory licences will be a taxable supply where the requirements of s.9-5 of *A New Tax System (Goods and Services Tax) Act 1999* (GST Act) are met.

The exemptions outlined in the GST Act for input taxed (exempt) supplies and GST-free (zero-rated) supplies apply equally to business assets. For example, the sale of the inventory of a pharmaceutical business may include GST-free supplies of medical aids and appliances. In a similar vein, the sale of receivables or a supply of a charge over the assets of a company would be an input taxed financial supply. GST in Australia is based on a consumption model rather than a production model; consequently, the standard principles for determining GST liability and entitlement to input tax credits apply equally to capital assets and inventory. This is not the case in some overseas jurisdictions.

"Carrying on" an enterprise is defined in the GST Act to include doing anything in the course of the commencement or termination of the enterprise, such as the final sale of assets in winding up a business.

The major exception to the application of the standard GST provisions is where the sale of the business constitutes a supply of a going concern. The supply of a going concern, as defined in the GST Act, allows for the sale of business assets to be GST-free. This is discussed below.

Sale of Shares

A sale of shares is a financial supply, which is input taxed where the vendor and purchaser are Australian resident companies and the supply takes place locally. Australia also recognises GST-free financial supplies where either of the vendor or purchaser are non-residents and not in Australia in relation to the supply or "acquisition – supply" (see below) of shares. Consequently, if the sale or purchase of shares is a GST-free financial supply, input tax credits can be claimed in relation to acquisitions related to making (or receiving that financial supply), such as legal and accounting services.

Unique to Australia's GST regime is a provision that deems that the entity that acquires an interest in a financial supply is also a supplier of that same interest. The effect is that both the supplier and the recipient make input taxed (or GST-free) financial supplies to each other.

The recipient's "supply" has been described by the Commissioner of Taxation (Commissioner) as an "acquisition supply". The practical consequence is that the recipient is unable to claim input tax credits for any GST incurred on services that it acquires as part of receiving the input taxed financial supply. For example, taxable

supplies of accounting, legal or brokerage services provided to the recipient cannot form the basis of an input tax credit entitlement (although there may be an entitlement to reduced input tax credits) as these supplies have been acquired in the course of making the recipient's input taxed "acquisition supply". If the financial supply is GST-free however, then any party to that share acquisition that is registered for Australian GST can claim input tax credits.

Assumption of Vendor Liabilities by the Purchaser

The GST Act defines "supply" broadly. Section 9-10(2) provides a non-exhaustive list of supplies, which includes goods and services, but also extends to other characterisations of supplies. Relevantly, one of these characterisations, contained in s. 9-10(2)(g) of the GST Act, has the effect that a "supply" can include:

> "(g) an entry into, or release from, an obligation:
>
> (i) to do anything; or
>
> (ii) to refrain from an act; or
>
> (iii) to tolerate an act or situation;"

Contracts for the sale of a business will often have multiple obligations between both parties. For example, the purchaser may enter into an obligation to honour and complete contracts with third party recipients. A purchaser may also enter into an obligation to assume responsibility for product warranties, long service leave obligations to employees, environmental rehabilitation, rent, rates, land tax, plant and equipment or property leases. Read strictly, each obligation related to the sale of a business could trigger a supply for GST purposes under s.9-10(2)(g).

Goods and Services Tax Ruling GSTR 2004/9 *Goods and services tax: GST consequences of the assumption of vendor liabilities by the purchaser of an enterprise* (GSTR 2004/9) deals with the GST treatment of a purchaser assuming a vendor's liabilities. The basic rule established by GSTR 2004/9 is that when a vendor supplies an enterprise to a purchaser, the purchaser does not separately make a supply of assuming the vendor's obligations and releasing them from those obligations. A purchaser that enters into obligations which are incidental to the running of the enterprise concerned does so as part of the transaction for purchasing the business. No separate s.9-10(2)(g) supply is made. This principle applies regardless of:

- whether the purchaser is assuming quantified or unquantified liabilities;
- whether or not the purchaser is assuming the vendor's interest in existing contracts;
- whether or not the purchaser is indemnifying the vendor in respect of claims by third parties for assumed liabilities; and
- whether or not the purchaser agrees to (and receives money to) honour employees' entitlements.

The relevant GST treatment for the sale of an enterprise, and the associated assumption of the vendor's liabilities by the purchaser, will depend on whether the supply is a supply of a going concern as defined in the GST Act.

Apportionment Issues

The Commissioner has released a new public GST ruling to clarify the meaning of creditable purpose. Broadly, the ruling sets out that acquisitions will be made for a creditable purpose if "there is a connection between the thing acquired and the enterprise, based on all the facts and circumstances".

Most significantly, however, the Commissioner has changed its previously published view with respect to the claiming of input tax credits on acquisitions relating to M&A deals in certain circumstances. According to the Commissioner, no longer should a taxpayer just deny credits from when the decision is made to make input taxed supplies. The Commissioner states taxpayers have to apportion credits based on the various options being considered.

This new public Goods and Services Tax Ruling 2008/1: Goods and services tax: when do you acquire anything or import goods solely or partly for a creditable purpose? (**GSTR 2008/1**) is, in the main part, unchanged from its earlier draft version (**GSTR2007/D1**). It sets out the Commissioner's views for determining whether an acquisition is made in carrying on an enterprise and whether the acquisition relates to supplies that would be input taxed or for a private or domestic nature. It says the assessment is to be an objective one, taking into account factors such as whether "the acquisition secures a real benefit or advantage for the commencement, continuance or termination of the enterprise" and whether "the acquisition is one which an ordinary business person in the position of the recipient would be likely to make for the enterprise". In doing so, it extensively refers to principles derived from income tax cases.

The ruling also sets out that the Commissioner will apply the principles determined in the Federal Court case, *HP Mercantile Pty Limited v Commissioner of Taxation [2005] FCAFC 126* in determining whether the requisite connection does exist in any given case. This means that the entitlement to input tax credits will be blocked where the connection between an acquisition and input taxed (exempt) supply is "direct, or indirect, substantial or real".

Significantly, there is a change resulting from the new ruling which is relevant to taxpayers that are considering a number of options involving different types of supplies, such as in M&A deals, where the decision has not been made whether, for example, to sell assets (typically, these supplies are a GST-free supplies of a going concern or taxable supplies) or shares (which are usually input taxed supplies). In the past, the Commissioner had stated that where the taxpayer was considering a number of options, one of which would be input taxed, an acquisition was still for a creditable purpose until a decision was made to pursue the input taxed option as in the input taxed sale of shares.

The Commissioner now states that the input tax credits should be apportioned based on the options that were being considered, even where no choice has been made. In effect, the previous safe harbour contained in an example in another ruling - GSTR2002/2 - has been removed.

Taxpayers who previously approached this issue by drawing a line in the sand when a decision was made about making input taxes supplies and only then start denying recovery of input tax credits, will have to reconsider their approach.

Many practitioners are familiar with the Commissioner's "Belvedere" example in GSTR 2002/2. The example, as originally drafted, was in the context of an enterprise, Belvedere, acquiring services in preparation for an acquisition of another enterprise, Rochester Enterprises. The original Belvedere example drew a distinction between when an enterprise's acquisitions related to general business activity and when the acquisitions related to the making of input taxed supplies. The Belvedere example gained its reputation largely as a result of the HP Mercantile litigation. In the original example, Belvedere was entitled to input tax credits on acquisitions made before a decision was taken to proceed by way of share sales, as recorded in the company's minutes. The legacy is still evident in example 39 of GSTR 2002/2, which also still refers to decisions being recorded in minutes.

The amendments to the example are as follows:

Example 41: Success fee – single payment for services that partly relate to making ~~spanning the formation of intention to make~~ a financial supply.

> 272. Belvedere Ltd an investment company wishes to expand its operations into minerals exploration. It engages a merchant bank (Eagle Corp) to recommend a method (such as takeover, acquire assets, acquire a joint venture or partnership interest) by which the expansion may be most effectively achieved, and to facilitate the expansion once the method has been approved by the Belvedere Board. Eagle Corp will receive a success fee on completion of the arrangement.
>
> 273. After three months of due diligence activities, Eagle Corp recommends to Belvedere Ltd that a takeover of Rochester Enterprises (a medium sized minerals exploration company) will provide the best vehicle for its proposed expansion. At Belvedere's next Board meeting, the directors agree to proceed with the acquisition of a controlling interest in Rochester Enterprises and record this in the Board minutes. The arrangement of the acquisition of the shares in Rochester Enterprises takes Eagle Corp a further six months to complete. At that time, it furnishes Belvedere Ltd with a tax invoice for all of the services rendered. Belvedere Ltd accounts for GST on a non-cash basis and remits monthly. Belvedere Ltd will need to ascertain the extent of creditable purpose relating to its acquisition from Eagle Corp to determine its entitlement to input tax credits in that month's tax period.
>
> 274. The services rendered prior to the activities of arranging the acquisition of Belvedere Ltd ~~forming an intention to acquire the shares of Rochester enterprises (at the Board meeting) are for a creditable purpose while services after that date are not for a creditable purpose as they relate to making supplies that would be input taxed.~~ need to be apportioned in light of the type of due diligence advice provided by Eagle Corp. to the extent that the due diligence conducted relates to an option that, if adopted, would lead to the making of input

taxed supplies, the acquisition of the advice would not be creditable. conversely to the extent that advice relates to an option that, if adopted, would lead to the making of taxable supplies, the acquisition of the advice would be creditable. The services of arranging for the acquisition of shares in Rochester are not for a creditable purpose as they relate to making supplies that would be input taxed. ~~The acquisition of the services from Eagle Corp is only partly creditable, and Belvedere Ltd is entitled to an input tax credit only to the extent the acquisition is creditable. 107~~ Belvedere Ltd may be entitled to a reduced input tax credit under item 9 of sub regulation 70-5.02(2) in respect of the services acquired concerning the arrangement of the acquisitions of shares in Rochester enterprises ~~after the intention to make a financial supply was formed~~. (Whether Belvedere Ltd is entitled to reduced input tax credits for the acquisition depends on the other requirements of Division 70 being met and whether in substance and reality the services acquired come within item 9).

The practical implications are a potential minefield. On the basis of the original Belvedere example, a business could rely on a decision date. Prior to the decision date, all acquisitions were creditable; after the decision date, an apportionment was required as to whether the acquisition related to the making of an input taxed supply. This was an effective and practical solution. The revised example now generates a mire of uncertainty, as businesses must analyse whether an acquisition that relates to a contemplated input taxed supply (i.e. a supply that may or may not happen) is creditable. Issues of remoteness must now also be considered to reflect Hill J's comments that there must be a "direct, or indirect, substantial or real" connection with the acquisition to the making of the input taxed supply.

Businesses must understand that the effect of the amendments is that preparatory and due diligence type acquisitions may now not be creditable notwithstanding that no decision has been taken to proceed with the making of an input taxed supply.

Going Concerns

GST Concession for supply of a Going Concern

In Australia, the supply of a going concern is GST-free. The requirements for making a supply of a going concern are set out in s.38-325 of the GST Act:

- the supply must be for consideration;
- the recipient must be registered, or must be required to be registered, for GST;
- the supplier and recipient must have agreed in writing that the supply is of a going concern;
- the supplier must supply the recipient with all of the things that are necessary for the continued operation of an enterprise; and
- the supplier must carry on the enterprise until the day of the supply (whether or not as a part of a larger enterprise carried on by the supplier).

It is worth examining two points in further detail.

What are all of the things that are necessary?

The requirement that the supplier supply all of the things which are necessary for the continued operation of the relevant enterprise is broad. The things that will be necessary for the continued operation of an enterprise must be taken by referring to the ambit of the enterprise. Importantly, the supply does not need to be all of an enterprise; it is sufficient for the supply to be only part of an enterprise, so long as that part of the enterprise is capable of being an enterprise. Goods and Services Tax Ruling GSTR 2002/5 titled *Goods and services tax: when is a 'supply of a going concern' GST-free?* (**GSTR 2002/5**) provides guidance on the "elements" which are essential for the continued operation of an enterprise:

- *the assets necessary for the continued operation of the enterprise including, where appropriate, premises, plant and equipment, stock-in-trade and intangible assets such as goodwill, licences and quotas; and*
- *the operating structure and process of the enterprise consisting of the commercial or economic activity relevant to the type of enterprise being conducted, for example, ongoing advertising and promotion.'*

Whether something is "necessary" turns on the particular circumstances. For example, in some cases, the premises will not be necessary for the continued operation of an enterprise (the Commissioner's example is of a clairvoyant who works from home). In other cases, premises will be necessary. The Commissioner's example is that:

> *'Heavy Duty Ltd manufactures earth moving equipment in its suburban factory. Heavy Duty Ltd intends to sell its manufacturing business. The factory floors have been specially modified to handle the extreme weights of the manufacturing plant and earth moving equipment produced. Heavy Duty Ltd must supply the factory as one of the things that is necessary for the continued operation of the enterprise.'*

Moreover, the Commissioner gives another example of where the purchaser does not wish to take the premises from the vendor because the purchaser already has its own suitable premises. In that scenario, the Commissioner takes the view that if the premises were one of the things necessary for the enterprise, then if they are not supplied by the supplier, the criteria for GST-free supply of going concern treatment will not be satisfied.

Therefore, decisions must be made on what things are necessary for the continued operation of the enterprise. Whether things such as premises, licences, rights, goodwill, restrictive covenants, intellectual property, franchises, shares and staff are necessary things will depend on the nature of the enterprise.

What is for the Continued Operation?

The sale of a property, subject to a lease, may constitute a supply of a going concern, assuming the other elements of 38-325 are met. In these circumstances, the enterprise is characterised as a "leasing enterprise". A critical issue is often whether the vendor has supplied all of the things necessary for the continued operation of the leasing

enterprise where a valid lease is not on foot at the day of supply (namely the completion date). The Commissioner's position in GSTR 2002/5 is that the vendor will have supplied all of the things necessary for the continued operation of the enterprise if it either supplies the property subject to a lease or is actively marketing for the leasing of the property.

A property can still be actively marketed where there are temporary vacancies caused by the vendor carrying out renovations or refurbishments. Further, if part of the property is not subject to a lease, it can be necessary for the continued operation, if it has a direct connection with the leasing enterprise. For example, storage rooms for cleaning and maintenance equipment and floorspace devoted to building management activities may still be a thing necessary for the continued operation of the leasing enterprise.

Options to acquire Going Concerns

GSTR 2002/5 deals specifically with the question of whether an option to acquire a going concern is covered by the GST exception for supplies of going concerns.

According to the ruling, s.9-30(1) of the GST Act, which sets out that "a supply is GST-free if it is GST-free under Division 38", extends to the supply of a right to receive a supply that would be GST-free under Division 38. The ruling states that, for an option to be GST-free, the supply of the option must be expressed in such a way as to make clear that the supply which is ultimately made will be a GST-free supply of a going concern.

Increasing adjustments

A purchaser of a GST-free supply of a going concern will be required to making an increasing adjustment under Division 135 of the GST Act where the purchaser intends to make supplies through the enterprise that are neither taxable supplies nor GST-free supplies.

Other issues

It is not necessary for the recipient of a GST-free supply of a going concern to actually continue the enterprise, although the supplier must carry it on until the day of the supply. The recipient could close down the going concern or sell the assets the day after acquiring the going concern. For example, a hotel may be sold as a going concern for GST purposes, and the very next day after the supply, the purchaser may close it down to start renovations to convert it into new residential premises.

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