

Selling A Business

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Important

This booklet is simply a collection of Newsflash articles relevant to selling a business. The articles are transferred from Newsflash into this booklet so it is best read from the back page forwards to ensure you are reading the latest article on the topic first. Note that the information contained in this booklet is not updated regularly so it is important that you seek professional advice before acting on it.

This booklet is a collaboration between BAN TACS Accountants P/L and Biznezmart. Each article has the author appearing in the heading. Should you have any questions in regard to the BAN TACS articles contact details are above or Biznezmart as follows:

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This information is general in nature so please do not act on in without getting advice regarding your particular circumstances.

General suggestions

Graham Long of Biznezmart

A serious buyer is interested in a business prepared and presented for sale. There is nothing more certain to put off a buyer than being presented with a buying proposition that looks 'shabby', has little or no records or information available to assist them to arrange the purchase. It is advisable to obtain professional advice from your broker early.

Preparing your business for sale is no different from preparing your products and services for sale to your customers. You go through a process that ends in successful income into your business. In a business sale, that process involves gathering all the information that purchasers will need so it is readily available and up to date, presenting that information, the premises, plant and equipment and your business operations neatly, cleanly, brightly and tidy.

If you use a broker to sell your business bare in mind this person is going to represent you and your business in the market place. Your broker is a marketing agent with financial know how out in the market place, not a financial agent. Your broker should be experience, qualified, capable and, most importantly, accessible to you and your business. This is very important if the broker is going to be able to keep abreast of your operations during the sale period. Always be fussy, be sure the broker is someone you can relate to, trust and expect 110% from, as they will make ALL the difference to the successful sale of your business.

Listen to your broker, it is in the brokers best interest to get you the best price possible, so if the broker indicates a major difference to your expectation, listen and take note of what the broker suggests to improve the salability of the business. An appraised opinion of value of your business for sale is strongly recommended, but it will not be free. Be prepared to get an opinion and pay for it ~ advise is worth what you pay for it - nothing worthwhile is free as we all know.

Arrange a profile of your business. The profile should cover most of the queries your purchaser will need to proceed. Place yourself in the purchaser's shoes; there is much the purchaser will need to know. Again, a professionally prepared profile will go a long way to assisting you with your sale and the settlement of that sale. Your profile really does represent you and your business to the purchaser and the purchaser's advisors. Keep your profile up to date.

It is not recommended you proceed with selling until your preparations are complete. The effectiveness of you sale will depend on:

Your price - Accurate pricing is critical to success. Your purchaser is not going to pay you an amount that cannot be justified. Be realistic, what did your professional valuation suggest?

Your Product - Your business is a product in the 'Businesses for Sale' market place. It should be prepared, presented well and attractive to your purchasers. It will be competing with other businesses in the same industry! The best proposition offered to the purchasers will be successful.

Your Promotion - No advertising equals no sale. But an effective, well priced and positioned, program of advertisements is likely to be more effective and inexpensive than one 'big splash'.

The Broker - A broker's business is selling businesses in the marketplace and is in the marketplace all the time. You can sell your business yourself, but can you afford the time away from your business? Do you want the emotional trauma of engaging in selling your business? Do you have the knowledge, tools of the trade, documentation, and skill to gain the best return? You may well find you are well served by appointing a broker to look after your interests.

What buyers will be looking for

By Graham Long of Biznezmart

- Assets** This is the plant and equipment and property owned by the business and available for acquisition. The depreciated (book) value is not usually very important. The present market value of the assets is important along with the importance of the plant and equipment for the business operations.
- Cash flow** Positive cash flow from the businesses actual operations is important. The buyer will be looking to see how much working capital is needed to keep the business running until the first sales are paid for and during seasonally slow times.
- Profit** The operational profit of a business is likely to be very different from it's assessable income for tax. Adjustments to assessable income to reflect operating profit need close scrutiny to determine if they are realistic.
- Inventory** Size, age, quantity, and method of valuing, storage costs, and obsolescence items, value of partly completed items of manufacture can affect business performance. Paying for inventory not there, or not useable is costly.
- Lease Tenure** No lease means you do not have any security of business income. Apart from other details about the lease, the lease needs to allow the buyer a sufficient period to profit from the business acquisition. Details of many other considerations are on the Business Sale Preparation Checklist below.
- Profile** A profile of the business should answer most of the queries a buyer will have again refer the checklist below.
- Inspection** A buyer will be looking at the business assets, inventory, business operation, premises, staff and systems.
- Training** The buyer will need to know what training you will offer. The clearer this is presented the more confident the buyer will be about buying your business compared with others.

Business Sale Preparation Checklist

By Graham Long of Biznezmart

<u>Activity & Item</u>	<u>Your Notes</u>
1. Lease Documentation Term, options and lease incentives available - Rent reviews, dates due, methods of calculation - Leased area - Zoning and permitted uses - Landlord details - Garbage/grease and waste traps and removal arrangements	
2. Trading hours and actual working hours	

<p>3. Staff-organisation, wages, benefits, awards, contracts, qualifications</p>	
<p>4. Major suppliers, their location.</p> <ul style="list-style-type: none"> - materials, products used 	
<p>5. Plant and equipment</p> <ul style="list-style-type: none"> - Inventory of all plant and equipment to be sold with the business - Lease details - Repair, condition, age replacement of obsolescent items - Capacity - Depreciation schedules 	
<p>6. Products and services you sell — a description of the items you sell</p>	
<p>7. Marketing and Distribution</p> <ul style="list-style-type: none"> - Customer profile, lists - Advertising programs and venues, prepaid advertising - Shop/premises presentation, tidiness, décor. - Methods/means of selling/delivering your products/services 	
<p>8. Competitors</p> <ul style="list-style-type: none"> - Location, size, products/services offered. 	
<p>9. Licenses, permits, patents</p> <ul style="list-style-type: none"> - Physical/documentary evidence required 	
<p>10. Administration and financial details</p> <ul style="list-style-type: none"> - Financial Statements (Performance and Position) for at least 3 years and preferably 5 years - Records remaining, invoices, customer lists, supplier lists - Manufacturing process/design, plans, formula - Insurances required - Franchise/licensing documentation and details 	

Benchmarking - The way forward

By Graham Long of Biznezmart

Benchmarking is setting 'marks' by which a business can improve- Really useful benchmarks are those that allow a business to be able to compare its performance directly with that of its competitors. Knowing sales turnover, profit margins, expenses, staff costs, floor areas, profitability etc which are industry wide surely is of immense benefit to your small business. Get the industry information that is real. Get 'in the know' of what is going on in your industry and use it. If your small business is performing to its optimum, chances are you have an excellent small business that you can expect to obtain a good price for in the marketplace when you decide to sell. We are in the business of getting you the best return for your business. We have benchmarks for:

Accountants	Health Food Retailers
Architects	Insurance Brokers
Art Galleries. Craft & Antique Shops	Jewellery Retailers
Auto Accessories & Spare Parts Retailers	Landscaping Contractors
Auto Electricians	Laundromats, Laundry & Linen Services
Bakery & Hot Bread Shops	Legal Practices
Beauticians	Liquor Barns
Bookstores	Medical Specialists (Other)
Bricklaying Contractors	Menswear
Building Contractors	Metal Fabricators/Engineering Works
Bus & Coach Operators	Milk & Fruit Juice Runs
Butchers	Motels
Cabinet Makers	Motor Mechanics
Car Dealers - New & Used	Newsagencies
Caravan Parks	Nursery & Landscape Supplies
Carpet Cleaning Contractors	Office Supply/Stationers
Child Care Centres	Osteopaths
Chiropractors	Painting Contractors
Cleaning Contractors	Pest Control Contractors
Coffee Lounges	Pharmacies
Commercial Printers	Photographic/Photo Processing
Computer & Phone Sales & Repair	Physiotherapists
Concreting Contractors	Plastering Contractors
Construction Companies	Plumbing Contractors
Consulting Engineers	Podiatrists
Consulting Surveyors	Public Hotel
Corner Stores/Mixed Business	Real Estate Agencies
Couriers & Taxi Trucks	Record & Music Retailers
Dentists	Restaurants
Desktop Publishing/Graphic Design	Road Transport Operators
Dry Cleaners	Rural Merchants
Earthmoving Contractors	Screen Printers
Electrical Appliance Retailers	Security & Night Patrols
Electrical Contractors	Service Stations
Fabric & Sewing Supplies	Smash Repairers
Financial Planners/Investment Advisers	Specialty Food Shops
Fish & Chips Shops	Sporting Goods, Toy & Outdoor Retailers
Fitness Centres	Supermarkets
Floor Covering Retailers	Surgeons
Florist Shops	Take-Away Food Retailers
Footwear Retailers	Taxi Operators
Fruit & Vegetable Retailers	Therapists, Counsellors & Psychiatrists
	Tiling Contractors

Furniture Retailers	Travel Agencies
Gardening Contractors	Tyre & Battery Dealers
General Medical Practitioners	Valuers
Giftware Retailers	Veterinary Practices
Glass & Aluminium Door/Window	Video Libraries
Manufacturing/Fitting	Women's Fashion Retailers & Children's
Hardware Retailers	Wear
Hairdressers	

Valuing a small business

By Graham Long of Biznezmart

This is a very complex area and readers should bear in mind from the outset, that this information is designed to be a general information guide for determining the value of a small business for sale purposes.

Most importantly, it is market evidence (sales of similar businesses) that is the best guide to the likely return from the sale of a small business. The methods used are used in an attempt to judge what the market return may be. Market evidence, however, is considered to be the overriding determinant. Readers are strongly advised to obtain opinions of value from professional practitioners who can provide market evidence of sales to support opinions given. Readers are strongly advised not to use the information herein to determine values because no market evidence is made available. Their attention is drawn to the disclaimer contained herein.

There are many methods for valuing small businesses. The commonly used ones are covered here. The method selected for valuing a small business is critical to the outcome because different methods can deliver very different results. The method selected, and the reasons for it, should be addressed early in the valuation process.

Commonly Used Methods

Market Value or 'Rule of Thumb'

The technique uses 'industry' turnover and multipliers of that turnover to determine value. It can be used as a basis for valuing small legal, accounting, veterinary, medical, financial planning, etc firms. It is a very unsatisfactory method because two similar businesses can have the same turnover but very different profit levels.

Asset Value - Going Concern

The method adds tangible and intangible assets to determine value. Tangible assets are items such as plant and equipment and stock. Intangible assets are usually goodwill. Tangible assets maybe, say \$75,000. Profit (Goodwill) maybe \$40,000. Estimated value, then would be \$115,000. This method often overvalues businesses, particularly those with large tangible assets basis.

Return on Investment

The technique uses the operational profit (before proprietor's earnings) of a business to determine value. The return sought is based on market evidence of similar businesses. Market evidence may suggest the Return on Investment (ROI) for a hairdressing business should be 80% for a business with a profit of \$100,000 per year. The Formula used is $Price = Net\ Annual\ Profit \times 100/ROI$. (Price = $100,000 \times 100/80 = \$125,000$ in the above example).

The better the business, the lower the Return on Investment (smaller risk taken), the better the anticipated price expected. It is a reasonable and quick method to estimate value because it uses market evidence as the basis of the determination.

The Market based expected returns are available from www.biznezmart.com.au for a fee.

Purchase of Past Profits/Capitalisation of Expected Future Excess Earnings

This method is the most thorough and likely to have the most accurate estimate of value. Judge McHugh has referred to this method of valuation in "Hepples v. Federal Commissioner of Taxation".

This method estimates price on the basis of the sum of:

Second Hand Replacement Value of working plant, fixtures, fittings and equipment.

+ A multiple of the estimated maintainable annual net operating profit (before proprietor's earnings) which reflects risk associated with the business (goodwill).

+ Stock (good and saleable) at invoiced landed costs (ie. SAV), discounted according to age and specific industry practice.

Work in Progress (if applicable).

Purchase of debtors (if being sold with the business which they often are not), discounted at a rate which recognises the risk associated with aged debtors.

The general principle behind the market's determination of the price estimate to be paid for the opportunity to the future profits of the business, the goodwill component of the value estimate, on the basis that the past profits of the business are maintainable into the future.

Goodwill is judged to be equal to a multiple (based on market evidence) of a period of either the maintainable gross income/fees, gross profits, net profits or excess earnings of the business based on its past performances. The method takes into account the risks to the purchaser that the past profits of the business will continue into the future. The less likely (therefore higher risk) that the profits will not be maintained, the lower the multiplier is to estimate goodwill.

The information provided is designed to take some of the mystery out of estimating the value of a business for small business owners in particular. It is a specialist field and readers wishing to establish proper estimates of value of business should contact professionals frequently in the small business sales market place who have market evidence of sales.

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CGT on the sale of a business

Julia Hartman of BAN TACS Accountants Pty. Limited

The following concessions are permitted regarding capital gains made on assets that are not plant and equipment, where the business qualifies as a small business entity under the Simplified Tax System or the Net business assets of the business and associates are less than \$6 million.

- a) The 50% capital gains discount - only half of the gain is included in your taxable income. This concession is not available if the asset is owned by a company. You must have held the asset for more than 12 months for this to qualify
- b) The 15 year ownership exemption. This requires you to have held the asset for more than 15 years. The asset must be an active asset. You need to satisfy the controlling individual test if the asset is owned by a company or trust. The taxpayer or the controlling individual, if a company or trust, must also be over 55 and retire or permanently incapacitated.
- c) Retirement exemption – can only apply to an active asset and the taxpayer or controlling individual must be over 55 and retire or put the funds into a super fund where they will not be taxed on entry or exit. A taxpayer can only process \$500,000 worth of capital gains this way in their life time. This does not require the asset to have been held for more than 12 months
- d) 50% discount for active business assets – can only apply to an active asset. This does not require the asset to have been held for more than 12 months.

- e) Rollover relief where an active asset can be sold and another active asset purchased or improved within two years or in the previous year. This does not require the asset to have been held for more than 12 months. From 1-7-07 if you don't spend the rollover you declare it as income or use the retirement exemption in the year the 2 years expires. Pre 1-7-07 you had to go back 2 years and amend

Note b) to e) from 1-7-07 require your net assets and those of your associates to be less than \$6mil or the business to be a small business entity. More than one of the above can be used if you qualify. It is not that difficult to meet the retirement condition but if that is the case you would not be looking to use the rollover relief. You can use the 50% capital gain discount together with the 50% active asset discount to only pay tax on only 25% of the gain.

For example:

Gain of:	\$100,000
Less 50% CGT Disc:	<u>50,000</u>
	50,000
Less 50% Active Asset Disc:	<u>25,000</u>
	25,000
Purchase A New Active Asset:	<u>25,000</u>
Amount subject to CGT	0

An asset is not an active asset if it is held merely for the purpose of earning rental income. From 1-7-07 to qualify as an active asset it must be used in a business, the business can be one owned by an affiliate, and it must be active for at least half the time it was owned or 7 ½ years whichever is the least.

There are problems if the asset is held in a company. Firstly the 50% capital gain discount is not available. The controlling individual test can not be met in many circumstances so the 15 year ownership or the retirement exemption may not be available. The active asset discount stays within the company. If you try and get the money out of the company (without putting in into a superannuation fund note possible age base limit problems) every dollar you receive, including the dollars that the company did not have to pay tax on because of the discount will be fully taxable as a dividend in your hands. Using the rollover relief provisions is only useful if you are buying another business and it will force you to continue to use the company so continuing the problem next time you sell.

Changes in the 2006 budget now mean that there can be up to 8 controlling individuals in any business.

Changes to the simplified tax system

Julia Hartman of BAN TACS Accountants Pty. Limited

The government is going all out to encourage businesses to use the simplified tax system (STS). One of the most significant changes relates to the small business capital gains tax concessions. These concessions are very lucrative and used correctly can mean a business owner pays no tax on the sale of a business. There are conditions including a \$6million asset test. But now this test has been abolished if the business qualifies for and elects to be in the simplified tax system. The budget also announced that the asset test to enter the STS had been abolished and the turnover threshold increased. Accordingly, the only requirement a business needs to meet to enter the STS is to have a turnover (total sales) of less than \$2million. It may well be time to change.

Other than the CGT concessions the other main advantage of being in the STS is accelerated depreciation. For example assets costing less than \$1,000 (net of GST if claimable) can be (optional) written off immediately. Note if they are part of a set the whole set must cost less than \$1,000. Assets costing more than \$1,000 but with a life expectancy of less than 25 years are placed in a pool and depreciated at a rate of 15% in the first year and 30% there after. Further if the business ceases and there is still a balance in the pool this amount can continue to be depreciated against other income without having to apply the non commercial loss rules (ID 2003/389). This applies even if the assets are now used for private purposes providing they have been held for more than 3 years. If the pool balance ever falls below \$1,000 it can be written off completely (Section 328-210). Note where a car is claimed under the 12% of cost method or the kilometre method it cannot be placed in a low value pool but if you change to one of these methods after the car has been in the pool for 3 years you do not have to remove it.

Large partnerships

Julia Hartman of BAN TACS Accountants Pty. Limited

From the 1st July, 2007 partners in large partnerships are much more likely to qualify for the small business CGT concessions. These can reduce the capital gain on the sale of your business to zero.

There are two tests, either of which will get you through the gate. The first test is electing for the simplified tax system (now small business entity) which means the partnership would have to have a turnover of less than \$2million, which is unlikely. The other test is net business assets of less than \$6million. Now a large partnership may well have more than \$6million in net assets but if the individual partner owns less than 40% of the partnership then only his or her share is taken into account.

Now your spouses business does not affect yours

Julia Hartman of BAN TACS Accountants Pty. Limited

There are two tests to qualify for the small business capital gains tax concessions. Passing either of them will do and it could mean the gain on the sale of your business is completely tax free.

One of the test is that your business has elected for the simplified tax system (small business entity) in order to do this the turnover must be less than \$2million. If you don't meet that criteria you may still qualify if your net business assets are less than \$6million dollars. Up until 30th June, 2007 your spouse's net business assets were included in this test. This is no longer the case if their business is not connected with yours.

When part of the selling price is conditional upon future performance

Julia Hartman of BAN TACS Accountants Pty. Limited

If when you sell your business part of the contract involves future payments contingent upon certain profit forecasts being met you need to consider this article. The right to these future payments are referred to as "earn out rights". That is when you sell the business you may receive some cash and an agreement that further payments will be made conditional upon performance. In the financial year that you sign the agreement to sell your business you will be assessable on the difference between the cost base of your business and the sale proceeds which are the cash you receive and the market value of the earn out right.

If you qualify for the small business capital gains tax concessions you will probably pay very little tax on the sale of your business. Businesses in the simplified tax system (STS) qualify for the small business concessions but they must have a turnover of less than \$2,000,000 to enter the STS. If you are not in the STS you can still qualify for these concessions if the business' and associates' net business assets are less than \$6,000,000.

The earn out right is a new asset that comes into existence when the contract to sell the business is signed and its cost base is the market value plus any associated costs such as legal fees. ID 2002/766 states that an earn out right is a C2 CGT asset. Unlike other CGT assets a C2 asset is deemed to be disposed of when the actual payment is received, not when the contract is signed. An earn out right is not an active business asset so will never qualify for the small business concessions but if there is 12 months or more between the signing of the contract to sell the business and receiving the payment then the 50% CGT discount can apply (ID 2002/941). If the performance criteria is not met so no payment is made this triggers a capital loss which can only be offset against future capital gains. The loss is the cost base or the portion of the cost base applicable to that payment. So you can see that the notional gain created by the market value of the earn out right when the business is sold is not reduced and all the seller is left with is a capital loss that cannot be utilised unless future capital gains are made. Accordingly, agreeing to an earning out right and setting the market value needs to be carefully examined. If the buyer wants this sort of security the seller needs to be compensated for waiting for his or her money, the risk that the buyer defaults or ruins the business and the fact that more tax will be payable on the future payments because they will not receive the small business CGT concessions.

The key factor here is determining the market value as this draws the line on how much will be taxed at the small business concession rates and how much will receive the 50% CGT at best. Setting a high market value will mean more of the sale proceeds relating to the earn out rights is taxed at the start but if the small business

concessions apply this tax may be negligible. The high market value becoming the earn out right's cost base will result in very little gain in the future when only the 50% CGT discount is available but if the payment is not received this will increase the loss that may never be utilised. On the other hand it may be a very cheap way of generating a future capital loss if you have an expectation of offsetting it against other capital gains that do not qualify for the small business concessions.

Of course in a perfect world market value would be market value but this one is very much in the eye of the beholder. Market value is the price a willing but not anxious buyer, dealing at arms length would pay for the asset. I personally would not pay much for an earn out right due to the high number of risk factors. What if the buyer ruins the business, defaults or other economic factors effect the industry, unlike the seller I would not have a knowledge of the sustainability of the business and be very weary of why he or she was selling. There is also the time value of money. Accordingly the market value of the earn out right would be considerably less than the total of the expected cash flows so unless the seller defaults there should always be a capital gain.

Tax free redundancy payments from your own business

Julia Hartman of BAN TACS Accountants Pty. Limited

Back in December 2002 the ATO announced that taxpayers who are employees of their own business that must apply to the ATO for approval if they pay themselves a tax exempt bona fide redundancy payment.

At the time we had a little rant about the ATO making up its own rules. Well the matter has finally gone before the courts and the ATO lost. Nevertheless the ATO is still making up its own rules. The case reference is Long v FCT 2007 ATC 2155. Important factors in the case were:

- 1) The payment was what would have been paid if the parties were dealing with each other at arms length
- 2) While the employee was involved in the decision to close the business, the need arose because their only customer terminated the contract.
- 3) Mrs Long's son also received a redundancy payment and he was not a director though other employees did not

The tax office has since issued a Decision Impact Statement claiming that the judgement is only limited to the particular facts of the case. The only thing the ATO is prepared to take on board from Long's case is that it is not an automatic exclusion from the redundancy concessions just because the employee was involved in the decision to terminate their own employment. The ATO certainly wouldn't approve of a bona fide redundancy payment to an employee (owner) who decided to sell the business. Not that this matters as in most cases the small business concessions provide all the tax relief needed.

For the 2008 financial year the maximum tax free bona fide redundancy payment an employee can receive is \$7,020 plus \$3,511 for each full year of service.

A bona fide redundancy payment is not always the best option if the directors are likely to be in a low tax bracket in the future, due to retirement, and the company has franking credits. It may be more appropriate to take the assets out of the company as a fully franked dividend and possibly get some of the franking credits refunded because the taxpayer's average marginal rate on all the dividend income is less than 30%. Once the company is closed the franking credits will be lost forever.

GST on selling a business

Julia Hartman of BAN TACS Accountants Pty. Limited

While we have covered this topic in detail before, this article is directed at the very small business owner who may not think it worthwhile to get professional advice for a small transaction. Firstly you are wrong as one new client just found out, one little slip up and the ATO get a windfall payment of GST that the legislators never intended them to have.

When GST was introduced it included a concession to help small business. You see if a small business changes hands and both the buyer and seller are registered the GST is just an unnecessary and temporary finance cost. They realised that it was silly to make the purchaser borrow more money just to pay the seller GST when as soon as the buyer put in their BAS they would get it back. In reality small businesses do not have the cash flow to finance the ATO's administration burden.

So the GST legislation included an exemption from GST for businesses sold as a going concern. There were a couple of simple conditions to prevent this being used to sell something other than a business or to prevent the buyer accidentally claiming the GST back. The legislation says at section 38-325:

- (1) The supply of a going concern is GST-free if:
 - (a) the supply is for consideration, and
 - (b) the recipient is registered or required to be registered, and
 - (c) the supplier and the recipient have agreed in writing that the supply is of a going concern.

- (2) A supply of a going concern is a supply under an arrangement under which:
 - (a) the supplier supplies to the recipient all of the things that are necessary for the continued operation of an enterprise; and
 - (b) the supplier carries on, or will carry on, the enterprise until the day of the supply (whether or not as part of a larger enterprise carried on by the supplier).

Pretty straight forward you would think. The trap the do it yourselfers fall into is not having the agreement in writing or not supplying a “going concern”.

It is the going concern definition that the ATO is having a field day with. They have a 29 page ruling, GSTR 2002/5 on the issue. This discusses the need to provide a lease on the current business premises, information necessary to continue the business, transfer licences, intellectual property, goodwill, franchise agreement and future bookings or contracts. You also have to be careful of the definition of the actual business you are selling. If it is part of another business you may not qualify as selling all things necessary if you only sell part of the business. Warning, if your staff abandon you just before the sale the ATO may argue that you did not continue to operate the business up until the day of transfer. Further, as you are required to transfer the information necessary to continue the business losing staff may make this impossible.

If you think by reading the ruling you can proceed with confidence you are a better person than me. When I sold a business I didn't even bother trying to meet the ATO's (at the time constantly changing) requirements of a going concern. I simply charged GST and gave the purchaser enough time to pay that it allowed them to lodge their BAS and get it back from the ATO. Solicitors will tell you they just put a clause in the contract that will allow you to recover the GST from the purchaser should the ATO decide GST is payable. The very fact they offer this shows you how little confidence the legal profession has in their ability to decipher what the ATO considers a going concern. I prefer to take the risk over the short term ie until the purchaser lodges their BAS then over the long term living in dread of the ATO questioning the contract.

So if you must (and we are certainly not recommending this) do the contract for the sale yourself. Better to charge GST and give the purchaser a tax invoice so they can claim the GST back. Because the ATO has no qualms about coming along, finding fault and collecting the GST off you even though they know the purchaser has not claimed it. The ATO has turned an attempt by the legislators to make things easier for business into a chance for them to collect tax where it was never intended by making things confusing.

This should not surprise us as they have been doing this sort of thing for over a decade now with the CGT main residence exemption.

Deregistering For GST

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When you de registered for GST you will need to pay back any input credits you had claimed on items for which the adjustment period has not expired? The adjustment periods differ depending on the cost of the item, as follows:

\$1,001 to \$5,000 GST exclusive – Go forward to the first 30th June after the item was purchased then add another 3 years. If this date has passed then no adjustment is necessary.

\$5,001 to \$500,000 GST exclusive – Go forward to the first 30th June after the item was purchased then add another 6 years. If this date has passed then no adjustment is necessary.

The amount you pay back is 1/11th of the current market value (GST inclusive) or the price you originally paid, whichever is the lesser.

This creates a problem if you are a small business entity using a low value pool. Just another reason never to believe they have simplified things for small business entities because you have to keep the records anyway. You will have to trace back to your documents on the original purchase because your depreciation schedule will not show the individual items in the pool.

If you have been claiming GST on a cash basis your final BAS must be prepared on an accruals basis ie take debtors and creditors into account.

Selling your business

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If when you sell your business part of the contract involves future payments contingent upon certain profit forecasts being met you need to consider this article. The right to these future payments are referred to as “earn out rights”. That is when you sell the business you may receive some cash and an agreement that further payments will be made conditional upon performance. In the financial year that you sign the agreement to sell your business you will be assessable on the difference between the cost base of your business and the sale proceeds which are the cash you receive and the market value of the earn out right.

If you qualify for the small business capital gains tax concessions you will probably pay very little tax on the sale of your business. Businesses in the simplified tax system (STS) qualify for the small business concessions but they must have a turnover of less than \$2,000,000 to enter the STS. If you are not in the STS you can still qualify for these concessions if the business’ and associates’ net business assets are less than \$6,000,000.

The earn out right is a new asset that comes into existence when the contract to sell the business is signed and its cost base is the market value plus any associated costs such as legal fees. ID 2002/766 states that an earn out right is a C2 CGT asset. Unlike other CGT assets a C2 asset is deemed to be disposed of when the actual payment is received, not when the contract is signed. An earn out right is not an active business asset so will never qualify for the small business concessions but if there is 12 months or more between the signing of the contract to sell the business and receiving the payment then the 50% CGT discount can apply (ID 2002/941). If the performance criteria is not met so no payment is made this triggers a capital loss which can only be offset against future capital gains. The loss is the cost base or the portion of the cost base applicable to that payment. So you can see that the notional gain created by the market value of the earn out right when the business is sold is not reduced and all the seller is left with is a capital loss that cannot be utilised unless future capital gains are made. Accordingly, agreeing to an earning out right and setting the market value needs to be carefully examined. If the buyer wants this sort of security the seller needs to be compensated for waiting for his or her money, the risk that the buyer defaults or ruins the business and the fact that more tax will be payable on the future payments because they will not receive the small business CGT concessions.

The key factor here is determining the market value as this draws the line on how much will be taxed at the small business concession rates and how much will receive the 50% CGT at best. Setting a high market value will mean more of the sale proceeds relating to the earn out rights is taxed at the start but if the small business concessions apply this tax may be negligible. The high market value becoming the earn out right’s cost base will result in very little gain in the future when only the 50% CGT discount is available but if the payment is not received this will increase the loss that may never be utilised. On the other hand it may be a very cheap way of generating a future capital loss if you have an expectation of offsetting it against other capital gains that do not qualify for the small business concessions.

Of course in a perfect world market value would be market value but this one is very much in the eye of the beholder. Market value is the price a willing but not anxious buyer, dealing at arms length would pay for the asset. I personally would not pay much for an earn out right due to the high number of risk factors. What if the buyer ruins the business, defaults or other economic factors effect the industry, unlike the seller I would not have a knowledge of the sustainability of the business and be very weary of why he or she was selling. There is also the time value of money. Accordingly the market value of the earn out right would be considerably less than the total of the expected cash flows so unless the seller defaults there should always be a capital gain.

Selling Your Business – Going Concern GST Concession

The Going Concern GST concession allows a business to be sold without having to charge GST. This can also include the building the business operates from if it is sold with the business. This is very relevant when a building is involved because the price will be lower so the stamp duty will be less. Of course reduced stamp duty only benefits the purchaser, so let's look at the risks on each side of the contract.

Firstly, a brief explanation of the requirements of a going concern clause: both the buyer and seller must be registered for GST and agree that the contract is the GST exempt sale of a going concern. The seller must also provide the buyer with all things necessary to continue the business and the seller must continue to operate the business up until the time of sale. If all these requirements are met the seller does not have to remit 1/11 of the selling price and the buyer is not entitled to claim GST input tax credits on the purchase. Accordingly, the property should be sold for 1/11th less than the market price for sales of similar properties that are not subject to the going concern concession.

From the Seller's Point of View:

All is good if you can still get the market value for the property, you have nothing to lose. But a well-informed purchaser would expect to pay less than market value for a property under the going concern concessions for reasons elaborated on in the Purchaser's point of view below. Your biggest concern is that the ATO will come along and decide that the going concern concession did not apply to the contract, for example because you did not supply all things necessary to continue the business. This issue is addressed in GSTR 2002/5 which has just recently been updated. Don't underestimate the ATO here; they even consider that key staff members need to agree to work for the purchaser. If the ATO considers that the sale does not qualify for the going concern concessions it can ask for 1/11th of the sale price in GST, which is totally unfair if you have sold for below market value because of the going concern clause. Solicitors will generally try to protect you from this outcome by putting a clause in the contract requiring the purchaser to pay you the GST if the ATO decide that the going concern concession does not apply. The problem may then be finding the purchaser and, if you do, then going through the court process of making them pay up.

From the Purchaser's Point of View:

The purchaser is considered to have received a GST input credit on the purchase even though no money changes hands. This means that should you change the use of the building to residential, de register for GST or just stop using it to make supplies that are subject to GST, section 135 requires you to pay back to the ATO the notional GST on the purchase. This of course is unfair if you have already paid full market value for the property, it could be as much as 1/10th of the purchase price.

If the ATO come along and deny the going concern concession to the sale then the purchaser, if they can obtain a taxed invoice, may be entitled to an input credit for the amount of GST the seller has to pay. This is quite a bonus if the contract doesn't have a protection clause stating that the purchaser has to pay the GST amount to the seller should the ATO deny the going concern concession.

The Margin Scheme:

A seller can reduce the amount of GST they pay out of the sale proceeds of a property by making the contract subject to the margin scheme. The catch here is you can't apply the margin scheme to sales that are exempt under the going concern concession and the purchaser must agree to the use of the margin scheme before settlement. So choosing to use the going concern concession instead of the margin scheme may completely eliminate the GST rather just a portion of it under the margin scheme but if the ATO decides that it didn't qualify as a going concern then you are left with full GST rather than the reduction under the margin scheme. You can apply to the ATO for an extension of time to apply the margin scheme after the contract is completed but the purchaser has to agree. In the event of the going concern concessions being denied the purchaser is unlikely to agree to the margin scheme because this means they are not entitled to any GST input credits, something that they would qualify for if the ATO deny the going concern concession.

The Fine Print:

Quite often the business and its premises are owned by different entities (within the same family group) for asset protection purposes. To qualify for the going concern concession the building has to be part of a going concern. This means it is either sold with the owners established business or it is leased out and the going concern business is considered to be the business of leasing out the building.

Getting back to the situation where the building houses the business, it is ok to sell say the business from your trading trust and the building from your holding trust and bridge the going concern concessions but only if both are sold to the same purchaser. This means that the purchaser cannot have the asset protection advantage of owning the building in a different legal entity than the business. The purchaser needs to consider whether this is really worth the risk just to save some stamp duty.

Ask BAN TACS

For \$79.95 at Ask BAN TACS, www.bantacs.com.au/ask-bantacs.php, you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. We will include ATO references to support our conclusion. There is also a notice board where some askbantac users have generously allowed their question and answer to be published. Lots of good real life information.

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How to Make Sure Your Next Property Is a Good Investment

- Do you really know how much the property is going to cost you to hold?
- What name should the property be purchased in?
- Will this property fit your investment strategy and goals?
- What does the contract say about GST?
- How does the price compare with similar sales in the area?
- If it is negatively geared, how much capital growth is required before you breakeven?
- Do you know what records you need to keep and how?
- Are your financing arrangements maximising your tax deductions?
- What happens if interest rates rise?

.....and the list goes on!

To ensure you don't make a costly mistake with your next purchase make sure you see a BAN TACS Accountant before you sign



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