Considerations in buying or selling a business

This is the second in a series of articles on this subject.

Pre-completion Dividends

These are needed on a share sale in order to clear out any imputation credits sitting in the target company. They are not needed on an asset or business sale. They are only needed where more than 34% of the shares in the target company change hands (note that in calculating this percentage any prior transfers in the period during which the credits arose are aggregated).

On a share sale they are needed because of certain shareholder continuity rules. Those rules seek to ensure that the credit (ie benefit) is enjoyed by the same person who paid the tax. This prevents trading in imputation credits and illegitimate streaming of them.

The continuity rules require that the dividend be declared (but it need not then be paid) prior to the contract for sale of the shares going unconditional. The continuity rules are triggered where more than 34% of the shares are sold during the period during which the credits arose.

The usual manner in which imputation credits are dealt with is by way of a dividend declared and credited to the shareholders' current account. The purchase price is then allocated between the shares and the shareholder current account. Care is needed to ensure that the purchase price allocated to the shareholder current account matches the balance of that account. Failure to do so will result in a tax liability for one or other of the parties.

An alternative to utilising imputation credits by way of dividend credited to the shareholders' current account is a bonus issue. A company may utilise imputation credits by attaching them to a taxable bonus issue. In that case care is required to ensure that all shares are captured on the share sale transaction and that the purchase price is allocated evenly across the shares. Bonus issues are not commonly used in this way and do carry some, though small, tax risk. This risk is that they might not be treated as having a cost base and the sale proceeds attributed to them are treated as taxable. This risk is low. Banking or other restrictions may mean a bonus issue is the only means available to clear out imputation credits prior to sale.

Share Sales v Asset Sales

The choice of one or the other is not always available of course. The choice of a share sale will be inevitable wherever transferring ownership of the individual assets is not practical, (because the assets in question are so numerous or transferring them is otherwise complicated). Similarly, the choice might not be available where the seller has a strong preference for a share sale. That preference might reflect the seller's wish to ensure that all liabilities transfer with the business or the seller's wish to ensure that the proceeds are received at the shareholder level thereby avoiding tax problems on extricating the proceeds from the company.

Where a share sale is embarked upon, negotiation of warranties and in particular tax indemnities can be fierce. This process is best managed by:

a. Vendor due diligence, enabling the vendor to make early disclosure of items that are intended to operate against the warranties; and

b. Warranty thresholds, ie a maximum exposure and a minimum amount that must be exceeded before a claim may be brought.

Once these are agreed, negotiation of the warranties themselves is more straight forward. This begs the question at what amount these thresholds should be. In relation to minimum claim amounts this is often set at 1% of the purchase price, but not lower than $5,000. The maximum is ordinarily in the region of 33% to 50% of the purchase price, depending on the risk profile. Occasionally, no limits apply to tax matters. It is all up to negotiation.

Upon a share sale, the seller will often have to deal with third party interests. For example, the company may have issued share options, share warrants or other rights. Or employees may hold shares in an employee share scheme. Forethought is the best recipe here, ie when granting such issues, the company should reserve the right to repurchase them in the event of a third party sale. If no right of repurchase is reserved, negotiation is required. My experience is that option holders and the like fall into line where a third party sale is proposed and they take advantage of it as an exit strategy. Belligerence on their part is always possible. In that event the seller may have no option other than to pursue an asset sale or seek agreement of the buyer to complete a share purchase subject to the existence of the minority holdings.

In contrast to a share sale, an asset sale is generally a straight forward negotiation. Selected assets and employees are agreed upon. Debtors and creditors are often excluded. Warranty negotiation is usually limited to title, the state of the assets and items related to goodwill in the business. Liability does not pass to the buyer except to the extent of product defects in stock or partly performed work. Those matters are easily provided for.

For a corporate seller, the result of an asset sale will be receipt of the proceeds inside the company. Where the seller wishes to distribute the proceeds to its shareholders this can be problematic. Capital gains on sale (provided they are not realised with a related party) can be distributed tax free on liquidation, and not before. The timing of that liquidation therefore becomes crucial and often this imposes numerous other (preparatory) steps for the seller. In a private company setting this is not usually problematic, but great care needs to be taken to ensure that related party capital gain provisions are not inadvertently triggered.

Share sales, unlike asset sales, usually require preparation of completion accounts. These serve to fix the state of the company at the time of handover to the purchaser. Warranties then support those accounts thereby providing the purchaser with recourse against the vendor for any undisclosed liabilities.

Whilst this arrangement works well for commercial matters, tax issues make it complicated. Invariably, completion occurs mid-way through an income year for tax purposes. The completion accounts will therefore need to provide for an estimate of tax payable for the part year period up to completion. An adjustment process should be provided for to accommodate the extent by which the estimate proves to be incorrect.

Equally important is the issue of preparing and filing the tax returns for the income year/GST return period that falls either side of completion (a split year/Period). The norm here is for the purchaser to prepare and file these returns after consulting with the vendor about them. Usual wording is:

> "The Purchaser shall provide a draft of the company's tax return to the Vendor, together with reasonable working papers (including all assumptions relied upon in preparation of the tax computations) to ascertain the tax liability of the Company for the part of the income year relating to the period up to Completion. The Purchaser will allow the Vendor a reasonable period of time to review a copy of the draft tax returns prior to filing them."

Provision is also needed for other (eg GST) returns. It is also advisable to provide for cooperation between the vendor and purchaser in these respects. Sample wording is:

> "The Vendor and Purchaser shall cooperate with each other and their agents to the extent necessary to allow the Company to prepare the relevant returns that are to be filed after Completion."

Other considerations in buying and selling businesses (of which there are many) are saved for later articles.

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