MERGERS & ACQUISITIONS

Tax considerations through the lifecycle of a deal

Introduction

When navigating the complex landscape of mergers and acquisitions (M&A), understanding the associated tax issues and opportunities is crucial for ensuring an effective and efficient transaction.

Tax considerations are not merely a compliance issue – they are a strategic component that can shape the structure, timing and financial outcome of a deal.

By proactively addressing the tax considerations connected to a deal, companies and shareholders alike can optimise their tax positions, mitigate unforeseen liabilities, and enhance the overall efficiency of the transaction. A well-considered approach to tax can be the difference between a good deal and a great one.

This report explores the key tax considerations that arise throughout the lifecycle of a typical M&A transaction, from initial planning through to final stages of execution.

Phase 1 Pre-deal structuring

Phase 2 Due diligence

Phase 3 Sales contract review

About the Author

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Mark has over 20 years of experience in tax advisory and compliance work, which he has developed during his time in both Perth and Sydney with Grant Thornton, and before that, with a Big 4 accounting firm.

He has particular experience in the energy and resources, mining support services and technology sectors and holds a leadership role within the Grant Thornton Energy & Resources industry group.

Mark has been the lead technical adviser on numerous high-value domestic and international transactions, with experience representing both buy-side and sell-side interests. His extensive experience and strong technical expertise enable him to pinpoint critical tax risks and opportunities, while effectively guiding stakeholders through every stage of the transaction lifecycle.

Deals Snapshot

M&A deal volumes are down, but industry deal composition suggests **Australia's M&A landscape has largely stabilised.**

Recent trends in M&A

Mid-market businesses continue to dominate acquisition targets with a large proportion of deals having a transaction size of less than $100m, with services businesses a key area of interest.

Top industries in M&A

The composition of M&A deals by sector reflects a stabilisation of the deal market in Australia. While the trend towards innovation continues (particularly investment in AI, digital infrastructure and data), Industrials remain the biggest contributor to deal flow.

Domestic vs international deals

International acquirers have continued to buy larger businesses and pay higher valuation multiples than domestic acquirers. Of the total 82 deals with disclosed valuation data, 50 involved domestic acquirers, while 32 targets were acquired by buyers outside of Australia.

Increase/decrease in IPOs

The Healthcare sector exhibited the largest increase in the number of IPOs, from three to eight IPOs. Both the Consumer Discretionary and the Industrial sectors saw small increases in the number of IPOs, increasing by two and one listings respectively. The Materials, Financials and Energy sectors all saw a contraction in the number of IPOs, whilst Consumer Staples, IT, Telecommunications and Utilities saw no listings during the current period.

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1 Pre-deal structuring

Pre-deal planning and structuring

Effective tax structuring is crucial before entering an M&A deal and is necessary to ensure the target business is aligned with the requirements of the vendors/acquirers. Efficient tax planning can not only maximise shareholder value, but also minimise risks associated with unexpected tax burdens.

Key areas of focus and consideration

Understanding the exact nature of the business to be sold/acquired and ensuring the efficient and cost-effective execution of any restructuring required is critical.

1. Being sale ready

Ensuring that a business is 'sale ready' is critical for a tax-efficient transaction. Relevant considerations may include the formation of a tax consolidated group to facilitate tax-free transfers, or converting the target from a trust to a company in a manner that enables rollover relief.

Pre-deal repatriation of cash/profits to the shareholders is also common. In this case, consideration should be applied to making sure the franking credits are passed onto shareholders and to ensure that the dividends are not re-characterised as sale proceeds.

2. Structuring the deal

The tax consequences of a share deal (where history is inherited) versus an asset deal (which can be less practical) must be considered from both the perspective of the buyer, and seller and the impact it has on the purchase price.

For a share deal, the level a target business is acquired can materially impact the tax assets and liabilities inherited. This is of particular relevance for tax consolidated groups that hold material tax losses (common in mining and technology groups), noting that tax losses are held entirely by the head company of the group, and not the operating entity or entities that may have generated the losses.

3. Funding the deal

It's important to confirm that loan-funded arrangements qualify as 'debt' for tax purposes to ensure the associated interest is deductible.

Consideration should also be applied to foreign funding, particularly the withholding tax implications of the funding, and whether a 'gross-up' clause exists in the funding agreement that increases the cost of funding.

Assessability of alternative funding, such as payments for the rights to receive future income streams (i.e. royalties), may also need to be considered.

Related insight

[Tax planning essentials for successful M&A transactions]

5. Due diligence ready

When acquiring a company's shares, the buyer inherits its tax history. To mitigate risks, the buyer typically conducts financial, legal, and tax due diligence covering two to four years. Sellers should proactively assess the company's compliance obligations, tax processes and controls to minimise red flags. Major negative findings can lead to extended due diligence, price reductions, a shift to an asset sale (less tax-effective for the seller), increased warranties, or even deal termination.

6. Additional considerations

Exemptions and concessions may apply for stamp duty and GST purposes. Concepts such as 'going concern' and 'land rich' entities should be considered.

In a share sale, the buyer will often expect that intra-group debts are dealt with prior to the purchase, or if the seller has insufficient funds to repay the debt owing to a related party, some of the consideration may be directed towards the repayment. If rather than the debt being repaid, the debt is forgiven, there are a number of different tax consequences to consider.

Case study 1:
Locked out from losses – a costly mistake

To partially fund a group transitioning into mining development, a third-party investor acquired a 30 per cent interest in the soon-to-be mining developer through the injection of equity capital at the project entity level. The project entity was a subsidiary member of a tax consolidated group ('**TCG**'), and that TCG's primary focus was this this project.

By investing at the project level, the project entity exited the TCG as it was no longer wholly owned – a condition of membership. This was detrimental as the tax losses generated by the project entity through the exploration phase were held by the head company of the TCG, pursuant to tax consolidation law, and the losses were unable to be used to offset the future profits generated by the project entity.

2 Tax due diligence

Looking under the hood

Tax due diligence is crucial in M&A deals, forming the basis for informed decisions and risk mitigation. By reviewing the target businesses' tax history, liabilities, and compliance, acquirers can identify hidden tax risks and opportunities. This process aids in accurately valuing the target company and ensures unexpected tax burdens post-acquisition are minimised.

Key areas of focus and consideration

Outlined below are the key tax risk areas that are more likely to be scrutinised in a tax due diligence process, alongside key remediation options available to the buyer.

Key risks

- A lack of formal tax advice substantiating the tax treatment of major transactions raises concerns about the treatment itself, as well as the governance frameworks in place.
- A lack of detailed tax consolidation workings, and common and complicated aspects of tax law.
- Misclassification of mining or exploration expenditure which results in excessive tax deductions.
- A lack of substantiation supporting the use of tax losses, which is also a major area of ATO scrutiny.
- Payroll and superannuation requirements are common areas where errors arise (especially in relation to contractors), with businesses unaware of, or not meeting obligations, and Directors potentially being held personally liable.
- International tax is becoming increasingly complex. Issues such as permanent establishments, withholding tax, transfer pricing, and tax residency, along with new rules like hybrid mismatches, debt deduction creation, and thin capitalisation, make this area a minefield of potential tax issues.

Remediation options

- If major tax liabilities arise during the identification process, having the ability to adjust the purchase price to reflect this risk exposure is fundamental.
- Seeking indemnities and warranties from the seller is a useful mechanism to protect the buyer against specific liabilities that arise post transaction.
- Buyers can agree with the seller to rectify errors prior to sale, and that top-up taxes or penalties must be paid prior, or part of, the transaction.
- Depending on the degree of liability, an appropriate course of action may be to restructure the deal. It is key to seek pre-transaction advice to help with this process.

Case study 2:

Temporary full expensing trap successfully identified in due diligence

During the due diligence process it was identified that nearly all the assets within a PP&E rich target had been subject to temporary full expensing (‘**TFE**’). As the target was to enter the acquirer's tax consolidated group, the value allocated to the TFE assets (due to a quirk in the tax consolidation rules) was to be nil. This meant the acquirer was not able to claim tax deprecation deductions for the PP&E that had been allocated value under the cost allocation process.

As a result, there was an adjustment to the purchase price of the target, given the change in the target's Net Present Value.

Related insight

Tax due diligence in M&A – more than a box-ticking exercise

3 Sales contract review

Sales contract review

Reviewing sales contracts from a tax perspective is crucial. These contracts formalise transactions and significantly impact tax outcomes for both parties. A well-drafted contract accurately reflects the parties' intentions, incorporates agreed upon due diligence actions, and avoids unexpected tax liabilities. Key areas like purchase price adjustments, deferred consideration, and tax relief clauses must be scrutinised to prevent adverse tax consequences. Addressing these elements ensures a tax-efficient transaction, minimising risks and maximising value.

Key areas of focus and consideration

Specific actions should be taken to ensure that the necessary clauses, and wording within clauses, are included to facilitate a tax-efficient transaction that reflects the intention of both parties.

1. **Consideration structuring**

Consideration/pricing clauses should be carefully reviewed. While some consideration clauses are straightforward, others may include more complex elements. For example, deferred consideration that is contingent on the economic performance of the target can be taxed in a different way than deferred consideration that is contingent on other, non-economic metrics.

2. **Rollover relief**

Rollover relief is only available where non-cash compensation is received. Where rollover relief is not available, tax may be payable on the receipt of illiquid non-cash assets, which can create cash flow issues. It's critical that clauses are worded appropriately to allow for such relief to be available.

3. **Tax Warranty and Indemnity ('W&I') clauses**

W&I clauses need to be carefully and appropriately drafted to ensure that buyers are not inheriting unnecessary risk. However, W&I is only as good as the vendor's ability and willingness to pay. Therefore, alternative strategies, such as withholding a portion of the purchase price in escrow, should be considered.

4. **Tax consolidated groups**

A 'clear exit mechanism' is fundamental to ensure the subsidiary of a tax consolidated group does not remain joint and severally liable for pre-transaction tax liabilities of other members of the exited group.

5. **Each party's role**

It's important to understand and agree upon the respective responsibilities of the buyer and seller post-completion of the transaction. The SPA should specify who is lodging any straddle tax returns and review the rights of each party, including who will take carriage of a tax dispute, and who will bear the costs.

Case Study 3:
The importance of correct wording

From a review of the wording on the SPA, it was clear that not all shareholders who were disposing of shares in the target and compensated with shares in the acquiring entity were doing so on substantially the same terms. This would have resulted in the shareholders not being eligible for scrip-for-scrip rollover relief.

Had the wording in the SPA not been revisited and revised, the vendors would have been taxed on the disposal of shares and not had the necessary funds to pay the associated tax bill (noting the shares received were in a private company, therefore not liquid).

Related Insight

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Grant Thornton M&A services

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- Merger integration
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- Raising private equity
- Roll up / buy and build strategies
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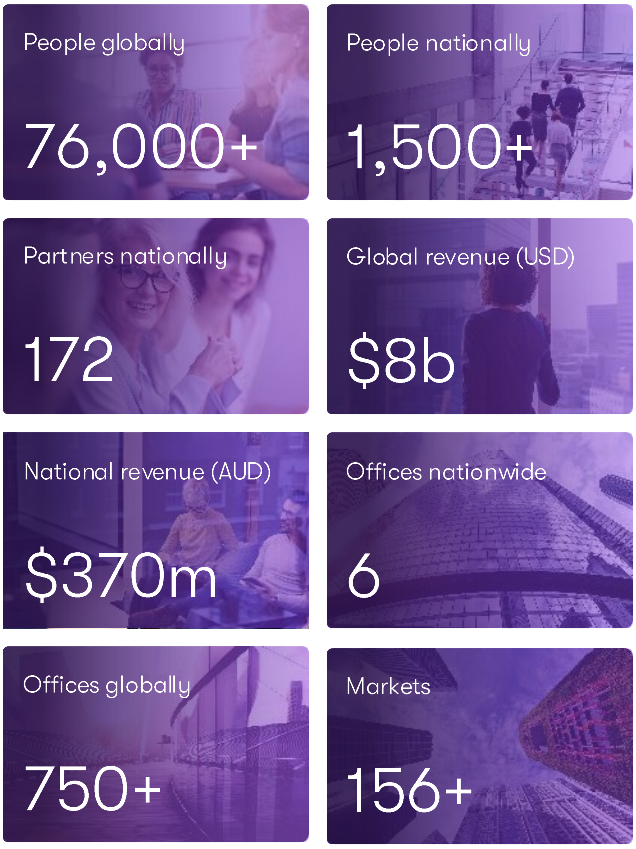

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