Grant Thornton

# Tax in M&A: Questions to ask your business and deal team

While Australia has shown strong acquirer appetite and businesses from all industries are finding great success and outstanding returns with their acquisition and divestment strategies, M&A activity now faces an uncertain future.

Grant Thornton's Dealtracker – our analysis of the Australian M&A and private equity markets – has demonstrated that despite COVID-19 trading conditions in the past 18 months, M&A deal volumes are up in Australia. In fact, this period has seen the highest level of deal volumes in the Australian market since 2010.

But what can be common in M&A deals are missed opportunities to optimise your tax, unnecessary tax leakage, not to mention identifying key tax risks to be mitigated. The more work you do at outset of a deal – while taking a long-term view of the transaction – can result in significant saved dollars.

Our Tax in M&A team regularly produces content on the latest developments and trends in M&A transactions. You can read in more detail here.

**Using this tool: Use this decision tree as a way to unpack and level up tax strategies for your M&A transaction.**

# Start the conversation...

## AT THE OUTSET

### Have we properly scoped the key tax issues on this transaction before we enter the deal?

A tax due diligence is a critical step in an M&A. The main objectives of the tax due diligence process is to assess potential risk areas and ensure corrective action is undertaken to mitigate any potential tax exposures. In this regard, a key step in the tax due diligence is ensuring that the scope of the procedures to be undertaken are tailored to the nature and profile of the target.

TIP

A properly-scoped tax due diligence will result in identifying and quantifying key risk areas with a view on likelihood of risk.

For example, it is important to:

- agree a materiality level given cost and time frames
- determine which taxes (income tax, GST, payroll tax etc) are covered and assess which areas are particularly risky based on profile and industry
- consider if a jurisdiction outside Australia needs to be covered
- assess if any comfort can be placed on any prior vendor due diligence.

## PROTECTION MECHANISMS

### Do we need Warranty and Indemnity insurance?

Broadly, W&I insurance protects the buyer of a company in the event that there is a tax claim post acquisition. If this occurs, the buyer can make a claim on the insurance policy.

This is usually easier than going into a lengthy dispute process with the seller to recover the tax liability.

TIP

Specific risks identified can be properly noted as a key warranty or indemnity. This avoids general drafting of traditional carve-outs.

**Communicate early:** All your advisers should be made aware that W&I will be procured at an early stage. This will impact how the due diligence is scoped and the agreed materiality thresholds for the review. Importantly, and sometimes overlooked, is that the seller should also be made aware what the W&I process entails.

**Scope:** Generally speaking, the scope of the tax due diligence has to be comprehensive in order to obtain full insurance coverage.

**Style:** Often insurers and their advisers will review this at the 11th hour and will not have the time or inclination to do a deep dive into a lengthy report. Detailed explanations and discussions on every document that was reviewed in the diligence must be avoided.

**Exclusions:** Exclusions from the standard scope of a tax due diligence have become common. It is important to keep in mind any exclusions from the scope of review, which then become exclusions from the W&I insurance policy. From a cost-benefit perspective, it may be advisable to extend the scope to include these items so you will end up with a more comprehensive W&I policy.

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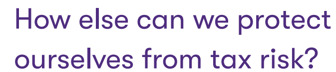

## How else can we protect ourselves from tax risk?

Post the tax due diligence, tax warranties and indemnities in a **share purchase agreement** (SPA) provide protection against tax claims that may arise as a result of the target's past activities.

**TIP**

Most experienced legal practitioners will insert a standard set of tax warranties and indemnities in a SPA. However, it is crucial that these warranties are reviewed by your tax due diligence team to provide any recommendations regarding the context of the particular transaction.

There are a number of considerations to navigate when negotiating – or planning to negotiate – a SPA.

- Withholding cash
- Time limits
- Disclosure exclusions
- Interest and penalties
- Tax liabilities or correcting tax issues as a condition precedent to completion.

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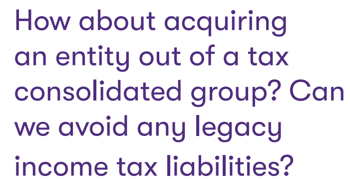

## How about acquiring an entity out of a tax consolidated group? Can we avoid any legacy income tax liabilities?

When undertaking an acquisition of a subsidiary company of a tax consolidated group, much effort and attention is devoted to ensuring that the target company is acquired free of any legacy income tax liabilities. However, obtaining a truly clear exit is often a lot harder than it seems. And this exit needs to be considered early on in your transaction.

**TIP**

Consider if the target has **valid tax sharing agreement** – and if it has a reasonable allocation.

A valid tax sharing agreement constitutes an agreement between the head company and the subsidiary members that is entered into before the due time for the group liability. In this regard, during due diligence, it is critical to scrutinise the TSA to, firstly, ensure all relevant entities are parties to the agreement and, secondly, confirm the date on which the TSA was entered into by the exiting member to ensure it covers all open tax periods.

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# MARKET CONDITIONS

## Are there arrangements and structures we should consider given the current uncertain and unpredictable economic climate ahead?

Different market conditions can bring about different impacts on a transaction – and most will be out of your control. But there are options to consider to lessen the impact when market dynamics are unpredictable.

**TIP**

An **earnout arrangement** can be preferable in unstable conditions. Typically, an earnout is an extended payment to the vendor post the deal closing, based on actual future earnings of the asset acquired, rather than the historic EBITDA. Earnout arrangements are a well-known way of pricing the sale of a business where there is uncertainty about value. This deal mechanism has been used in transactions for some time, but we are likely to see an increase of earnouts used in future M&A negotiations given the uncertain and unpredictable economic climate ahead.

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# DEAL STRUCTURE

## Have we structured this deal to maximise the tax synergies on acquisition?

Accelerated depreciation measures have changed the landscape of acquisitions. Due to market conditions (and as a result of some incentives created by Government to manage the immediate impact of COVID-19, including adjustments made to the Instant Asset Write Off scheme), we are seeing a move away from share sales and begin purchasing the assets of targets that have utilised the accelerated depreciation incentives.

**TIP**

Share sales have historically been the most popular method of acquiring a target, as the purchaser can minimise the risk of stamp duty applying.

However, due to the modification of the tax cost setting rules on consolidation, and the abolition of stamp duty on the purchase of business assets in most states (excluding QLD, NT and WA), asset sales are likely to see a resurgence in the near future.

There are complexities to work through whichever structure you employ, therefore weighing up whether a share or assets sale is the most tax effective for you must be addressed at the outset of a deal.

Will the target join your tax group? If so, there will be an impact in tax profile.

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## What about stamp duty?

Stamp duty can impact tax obligations and add to the cost of M&A significantly.

Stamp duty obligations can be quite different depending on what type of transaction is chosen – that is, is it a share sale or an asset sale?

**TIP**

**Impact of landholder duty**

Share sales have typically been preferable from a stamp duty perspective (however, see above) – particularly when there is valuable, intangible business assets located in QLD, NT or WA. However, landholder duty exposure can be a blind spot. Landholder duty now catches many more transactions than the former 'land rich' regimes. All states and territories have moved away from the land rich concept, with only a threshold 'landholding' value enough to make a target entity a 'landholder'.

There are a number of complexities to navigate. For instance:

- Is it 'fixed to land'?
- Is it physically 'fixed' to something (eg a floor, wall or ceiling)?
- What state or territory does the asset lie?

These aspects should be considered carefully and identified early in a transaction and modelled if required.

**Post-acquisition restructures**

In the event the transaction is a share sale, it is typically desirable for a buyer to transfer the business from the acquired vehicle and wind it up. In most cases, in the event that duty would ordinarily apply to the restructure – subject to meeting the relevant criteria – an exemption from duty generally applies.

An application for exemption must be made to the revenue office – it is not self-assessable, and there are some deadlines to obtain the exemption. Some criteria for reconstruction exemptions are quite onerous. That said, with some care, it usually is achievable.

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# GST

## Could we be eligible for GST refunds?

When it comes to M&A transactions, businesses can often end up losing input tax credits. How do we determine if this is the case for our deal, and how much is recoverable?

**TIP**

There are a specific set of GST rules for the provision of financial supplies, which include M&A activity, IPOs, and the purchasing and selling of shares. While financial supplies are input-taxed and therefore do not attract a liability to remit GST, they generally have no GST recovery on expenses relating to these supplies.

The Financial Acquisitions Threshold ('FAT') must be considered as it acts as a mechanism to enable recovery of GST. The FAT is a threshold test that allows businesses that only make limited financial supplies to claim back all of the GST incurred on purchases that directly or indirectly relate to making the financial supplies.

This 'get out of jail free' card can be played when there are spikes of financial supply activity, such as IPOs or shares sales of a limited nature. However, where the FAT is exceeded, businesses may be blocked from claiming back the GST incurred on financial acquisitions.

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## ABOUT THE ASSET

### Are we acquiring a business with tax losses – or could be?

If not managed properly, acquiring a company with tax losses can be fraught with challenges. If the target entity has significant carried forward tax losses, the vendor can sometimes have an expectation that the purchaser should be able to obtain the tax benefit attributable to the losses in the future.

**TIP**

You may consider adjusting the purchase price so that the vendor is paid for the future tax benefit that will accrue to the purchaser when the losses are recouped.

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## ABOUT PEOPLE

### Do we have a full picture of employer obligations?

We are seeing an ever-increasing focus from multiple enforcement agencies on unpaid employee entitlements and the use of contract for hire labour. The significant uptick in compliance activity has coincided with exponential growth in the M&A space, leading many to believe there are huge levels of unquantified risk in the market – often not covered by warranty and indemnity insurance.

**TIP**

**Superannuation:** Always ensure superannuation is included in the due diligence scope and meaningful testing of timings and application is included. Where a shortfall risk is identified, commission further work to quantify and remediate the exposure. This is not a straight-forward exercise, but may pose a significant financial and reputational risk if left unchecked.

**PAYG:** Ensuring PAYG has been appropriately withheld and paid across is critical in due diligence. Where appropriate filings are not made, penalties can apply – which can be particularly punitive ($111,000 to $555,000) where the group is a Significant Global Entity (Revenue > $1bn). We recommend this area is not overlooked as underpaid PAYG can be the subject of Director Penalty Notices.

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### Are contractors or are gig workers part of the operations?

The definition of employee vs contractor is one that differs across all legislations. This often gives rise to misstatement, particularly for superannuation and payroll tax.

**TIP**

Do not rely on common law definition of employee as superannuation and payroll tax have a much broader definition to bring in genuine contractors. This should form a key focus of any due diligence in the face of increased compliance activity in this area and data matching programs.

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## WORKING WITH CLIENTS

Whether you are looking to increase market share, gain competitive advantage or influence supply chains, mergers and acquisitions can be an effective way to supercharge the growth of your organisation.

But there can be a number of complex tax issues – even tax concessions you're eligible for – of your M&A transaction.

Our team helps clients manage all tax aspects of M&A to ensure compliance and deliver business benefits. We work together to address potential issues by: undertaking due diligence; implementing tax-effective structuring & funding; managing capital gains and income tax; managing stamp duty and GST implications; ensuring that transaction documentation, such as Share Sale Agreements, have appropriate tax input; executing the transaction from a tax perspective and making sure all the tax obligations are done.

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