



Taxation of cross-border mergers and acquisitions

Australia

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Introduction

The Australian tax system is subject to ongoing legislative change and contains complex rules that, together with commercial and legal considerations, affect mergers and acquisition (M&A) transactions in Australia. Several significant developments in tax law have occurred since the last edition of this publication.

This report provides an overview of some recent developments and key Australian tax issues that are relevant for purchasers and vendors in M&A transactions in Australia. This report also discusses the Australian accounting and legal context of M&A transactions and highlights some key areas to address when considering the structure of a transaction.

Recent developments

Tax reform has proceeded apace in recent years in Australia. Many of the implemented and proposed changes affect the M&A environment. The key areas of focus include the following.

Recently implemented changes

Multinational anti-avoidance law (MAAL): The MAAL applies to groups with turnover greater than 2 billion Australian dollars (AUD) that implement certain 'schemes' that obtain a tax benefit on or after 1 January 2016. Similar to the UK's diverted profits tax, the MAAL targets arrangements that shift Australian profits into low-tax jurisdictions and/or avoid the creation of an Australian permanent establishment (PE).

Proposed changes

Foreign resident capital gains WHT: The Australian government has proposed a new law with effect from 1 July 2016 in respect of a new 10 percent non-final withholding tax (WHT) obligation on the disposal by foreign residents of certain Australian real property interests. The WHT obligations will apply to the purchaser of the

Australian real property interests. This regime is intended to assist with the collection of foreign resident's capital gains tax (CGT) liabilities arising on the disposal of Australian real property interests.

Earn-out arrangements: The Australian government has introduced a bill that contains changes to the CGT treatment of the sale and purchase of businesses involving certain earn-out rights. Where capital gains and losses arise in respect of look-through earn-out rights, these changes will retrospectively adjust the gain/loss for the vendor. This treatment applies to earn-out arrangements entered into on or after 24 April 2015. Previously, it was necessary to value all earn-out rights at the time they were provided. The old rules will continue to apply to earn-out rights that do not meet the definition of 'look-through' earn-out rights.

Tax consolidation deductible liabilities: The Australian government released draft legislation that proposes to amend the tax consolidation provisions for the treatment of liabilities brought into a tax-consolidated group by a subsidiary member. The proposal's purpose is to prevent a double benefit that could arguably arise in relation to certain liabilities held by a joining entity that is acquired by a consolidated group. However, if the proposals are enacted, an upfront cash tax cost could arise on formation of a tax-consolidated group that may only be recovered over several years (if at all). These changes need to be considered as part of the tax structuring of transactions.

Attribution MIT: The Australian government issued draft legislation with effect from 1 July 2016 (with an option of early adoption from 1 July 2015) in respect of a new managed investment trust (MIT) tax regime. A MIT is a structure commonly used by non-Australian resident investors in property assets. The proposals would introduce (among other things), a MIT attribution model to determine income amounts taxable to the beneficiaries and broaden the test for the widely held ownership requirement in order to qualify as a MIT. These changes should improve the availability of the regime and provide greater certainty for investors. See attribution MITs later in this report for details.

Tax losses carried forward: The Australian government has proposed changes to the tests applied in order to continue to access tax losses carried forward following a change in ownership as follows:

- The current same-business test will be relaxed to allow businesses to access prior-year losses when they have entered into new transactions or business activities.
- Under a new and more flexible ‘predominantly similar business test’, companies will be able to access losses where their business, while not the same, uses similar assets and generates income from similar sources.

Base erosion and profit shifting (BEPS): In 2015, the Organisation for Economic Co-operation and Development (OECD) released a number of reports dealing with the various aspects of the BEPS program, which arose from concerns by national governments that multinational groups were not paying what they considered to be their ‘fair share’ of tax. At the time of writing, the Australian government has thus far adopted a ‘wait-and-see’ approach to the OECD reports’ recommendations.

Changes to the GST legislation: Several changes to the Goods and Services Tax (GST) law have been proposed and are forecast to be implemented over the next 2 years. Changes affecting business-to-business transactions will have effect from 1 July 2016, while changes affecting business-to-consumer transactions will have effect from 1 July 2017.

Broadly, this legislation aims to:

- bring into the Australian GST system non-residents who supply intangibles and services to Australian resident end consumers (sometimes referred to as the ‘Netflix tax’)
- remove from the GST system non-residents who supply, through their overseas business, intangibles and services (and goods in limited circumstances) to GST-registered businesses.

While these changes may not have an immediate impact on any particular merger or acquisition, it will be necessary to consider how they may affect transaction costs incurred in the course of undertaking the transaction, and potentially any future supplies made by the entity acquired.

Asset purchase or share purchase

A foreign entity that is considering acquiring an existing Australian business needs to decide whether to acquire shares in an Australian company or its assets. Many small and medium-sized businesses in Australia are not operated

by companies. Trusts are also common, and, in these cases, the only choice usually available is the acquisition of business assets. For larger businesses, the company is by far the most common structure. The commentary in this report focuses mostly on companies, although much of it applies equally to other business structures.

Within Australian corporate groups, the distinction between share and asset transactions is largely irrelevant for income tax purposes due to the operation of the tax-consolidation rules. Generally, these rules treat a sale of shares as if it were a sale of assets. The purchaser is then effectively able to push the purchase price of the target down to the underlying assets. The distinction is more important when dealing with other taxes, such as stamp duty and GST.

Hence, the decision to acquire assets or shares is normally a commercial one, taking into account the ease of executing the transaction and the history of the target.

Purchase of assets

Asset acquisitions often constitute a PE in Australia, with the assets forming all or part of the business property of the PE. Accordingly, the disposal of the assets is likely subject to CGT, whereas the disposal of shares by a non-resident is not ordinarily subject to CGT.

Purchase price

The total consideration must be apportioned between the assets acquired for tax purposes. It is common practice for the sale and purchase agreement to include an allocation in a schedule, which should be respected for tax purposes provided it is commercially justifiable. There may be a tension in this allocation between assets providing a useful cost base for income tax purposes and the stamp duty payable on the acquisition.

Although there are no specific income tax rules for allocating the purchase price among the various assets purchased, the market value consideration provisions in the CGT rules in effect arguably permit the Australian Taxation Office (ATO) to determine an arm’s length transfer price different from that allocated to the asset by the parties.

Additionally, earn-out purchase price mechanisms are commonly used in asset deals where the value of the business asset is uncertain. Broadly, under these mechanisms, as proceeds for the sale of a target’s business assets, the vendor receives a lump-sum payment plus a right to future payments that are contingent on the performance of the business (i.e. earn-out right). See proposed changes above in respect of earn-out rights.

Goodwill

Goodwill paid for a business as a going concern generally cannot be deducted or amortized.

Therefore, the purchaser may wish to have the purchase and sale agreement allocate all or most of the purchase price to the tangible assets to be acquired, thus reducing or eliminating any element of the purchase price assigned to goodwill. However, the lower price paid for goodwill also represents its cost base for CGT purposes, so this may increase the CGT exposure of the purchaser in any subsequent sale. The impact on stamp duty liabilities should also be considered.

Depreciation

Most tangible assets may be depreciated for tax purposes, provided they are used, or installed ready for use, to produce assessable income. Rates of depreciation vary depending on the effective life of the asset concerned.

Capital expenditure incurred in the construction, extension or alteration of a building that is to be used to produce income may be depreciated for tax purposes using the straight-line method, normally at the rate of 2.5 percent per year. Entitlement to this capital allowance deduction accrues to the building's current owner, even though the current owner may not be the taxpayer that incurred the construction costs. The current owner continues to write off the unexpired balance of the construction cost.

An important consideration in any acquisition of Australian assets or shares in an Australian company that joins a pre-existing tax-consolidated group is that, as part of the pushdown of the purchase price, depreciable assets can have their tax cost base reset to a maximum of their market value. In this scenario, any buildings acquired do not have their amortizable cost base increased, even though the tax cost base of the asset may be reset to a higher value. Capital allowances in respect of expenditure on these assets are generally capped at 2.5 percent per year of the original construction cost, regardless of the market value of the asset. The reset tax cost base of these assets is only relevant on a future disposal of the asset.

On the disposal of depreciable plant and equipment, the excess of the market value over the tax written-down value for each item is included in the seller's assessable income. Conversely, where the purchase price is less than the tax written-down value, the difference is an allowable deduction to the seller.

Relatively few payments giving rise to intangible assets may be amortized or deducted for tax purposes. Currently,

the main types of intangible assets that may be deducted or amortized are:

- software, including software used internally in the business
- cost of developing or purchasing patents, copyrights or designs, which are amortized over their effective life
- research and development (R&D) expenses incurred by eligible companies or partnerships of such companies
- capital expenditure, which can be deducted over a 5-year period, provided the expenditure is not otherwise taken into account (by being deducted under another provision of the tax law or capitalized into the tax cost base of an asset), the deduction is not denied under another provision, and the business is carried on for a taxable purpose.

In this context, a taxable purpose broadly means for the purpose of producing assessable income in Australia. For example, expenditure incurred in setting up a new foreign subsidiary, from which the dividend income will be exempt from Australian tax, is not be considered as related to carrying on a business for a taxable purpose.

The R&D tax incentive allows a 40 percent R&D tax offset for companies with turnover of AUD20 million or more. A 45 percent refundable tax offset applies for smaller companies/groups.

Tax attributes

Tax losses and franking (imputation credits) are not transferred as a result of an asset acquisition. The cost of depreciable assets is generally allocated as discussed earlier. However, a number of other matters must be considered:

- *Trading stock*: The disposal of the total trading stock is not a sale in the ordinary course of the seller's trading. Thus, the seller is required to bring into account the market value of that stock as income on the date of disposal. The purchaser is deemed to have purchased the trading stock at that value. In practice, the ATO generally accepts the price paid as the market value of the stock where the seller and buyer are dealing at arm's length or the transaction occurs as part of a corporate group reorganization.
- *Debt*: Debts should not normally be acquired when the assets of a business are acquired. A deduction for bad debts is not generally available to the purchaser since the amount claimed has never been brought to account as assessable income of the claimant/acquirer.

- *Prepayments*: When a business is acquired, it is preferable that any prepayments remain with the seller, as they may not be deductible by the purchaser.
- *Employee leave provisions*: Australian income tax law denies the deduction of employee leave provisions (e.g. holiday pay, long service leave). In most cases, a deduction becomes available only on payment to the employee, although there are limited exceptions relating to certain employment awards where the transfer of the provision may be deductible/assessable.
- *Work-in-progress*: The profit arising from the sale of work-in-progress is assessable income to the seller. The purchaser is fully assessable on the subsequent realization of that work-in-progress but obtains a tax deduction for the cost of acquiring the work-in-progress.

Foreign resident capital gains withholding tax

The Australian government has proposed a new regime that imposes withholding obligations on purchasers of certain Australian assets. The purpose of the regime is to assist in the collection of the CGT liabilities of foreign residents.

A purchaser that acquires certain Australian assets from a vendor that is a relevant foreign resident must pay 10 percent of the purchase price to the Commissioner of Taxation. The purchaser may withhold this amount from the vendor. The amount withheld will be 10 percent of the first element of the cost base of the asset (usually, the purchase price).

The obligation will apply to the acquisition of an asset that is:

- a direct or indirect interest in taxable Australian real property (TARP)
- an indirect Australian real property interest, or
- an option or right to acquire such property or such an interest.

Certain situations will be exempt from the withholding obligations, including transactions involving TARP (and certain indirect Australian real property interests) valued at less than AUD2 million and transactions conducted through an approved stock exchange.

Further, no obligation is imposed in certain situations where the vendor obtains a clearance certificate from the Commissioner of Taxation or where the vendor has made a declaration about their residency status or the nature of the interest in their asset.

The amendments apply in relation to acquisitions on or after 1 July 2016.

Value added tax

GST, the Australian equivalent of value added tax (VAT), applies to 'taxable supplies' (both goods and services), currently at a rate of 10 percent.

Disposals of assets have varying GST implications, depending on the nature of the transaction. If the sale of assets does not fall within the GST-free going concern exemption, the GST implications arising on the disposal of each asset need to be determined. A sale of assets is likely to be taxable, depending on the assets' nature.

For example, the disposal of trading stock, goodwill and intellectual property is normally treated as a taxable supply. A transfer of debtors is an input taxed (i.e. exempt) supply, and the GST treatment on the transfer of real property depends on the nature of the property. Commercial property is generally a taxable supply (but may be GST-free subject to meeting certain criteria), while residential property depends on whether it is 'new' (taxable) or second-hand (input taxed). Farmland is taxable but may be GST-free, subject to satisfying certain criteria.

The availability of input tax credits (GST credits) to the purchaser of a taxable supply of assets depends on how the purchaser intends or actually uses those assets. Generally, full credits are available where the purchaser intends to use the assets to make taxable or GST-free supplies. However, such credits may not be available where the assets are to be used to make input taxed supplies (e.g. financial supplies or residential leasing supplies). Where full credits are not available, reduced credits (equivalent to 75 or 55 percent) may be available subject to certain criteria.

Transfer taxes

The stamp duty implications of a transfer of assets depend on the nature and location (by Australian state and territory) of the assets transferred. Stamp duty is imposed by each state and territory of Australia on the transfer of certain assets. Each jurisdiction has its own revenue authority and stamp duty legislation. Exemptions, concessions and stamp duty rates differ substantially among the jurisdictions.

The assets to which stamp duty may apply in a typical acquisition of an Australian business include land and buildings (including leasehold land and improvements), chattels, debts, statutory licenses, goodwill and intellectual property. The specific types of assets subject to duty differ among the jurisdictions.

All states and territories, except New South Wales, Queensland, Western Australia and the Northern Territory, have abolished stamp duty on the transfer of non-real business assets, such as goodwill and intellectual property. New South Wales is scheduled to abolish such duty on 1 July 2016.

The maximum rates of duty range from 4.5 to 5.75 percent on the greater of the GST-inclusive consideration and the gross market value of the dutiable property. The purchaser generally is liable to pay this duty.

Stamp duty can make reorganizations expensive. For this reason, it is often important to establish the optimum structuring of asset ownership at the outset, to avoid further payments of duty on subsequent transfers. However, most jurisdictions provide relief from duty for certain reconstructions within at least 90 percent-owned corporate groups. Such relief is subject to a number of conditions that vary between the jurisdictions, including certain pre-transaction and post-transaction association requirements for group members.

Purchase of shares

Non-residents are not subject to CGT on the disposal of shares in Australian companies unless the company is considered to have predominantly invested in real property.

This exemption does not protect non-resident investors who hold their investments in Australian shares on revenue account. Broadly, the acquisition of shares with the primary intention of future re-sale, whether by trade sale or initial public offering (IPO), could be characterized as a revenue transaction, even though the sale would occur several years in the future. In this respect, the ATO has made determinations that affect Australian investments by resident and non-resident private equity funds.

Australia's double taxation agreements usually apply so that non-residents disposing of shares on revenue account are not subject to Australian tax if they do not have a PE in Australia. However, this can be overridden by Australia's general anti-avoidance rule (GAAR; also known as 'Part IVA').

As noted earlier in this report, the Australian government has introduced new 10 percent, non-final WHT measures for disposals by non-residents of certain Australian real property interests, which includes indirect real property interests.

Tax indemnities and warranties

In the case of negotiated acquisitions, it is usual practice in Australia for the purchaser to request and the seller to provide indemnities or warranties as to any undisclosed taxation liabilities of the company to be acquired. The extent of the indemnities or warranties is a matter for negotiation.

Tax losses

Where the target company is a standalone company or the head company of an Australian tax-consolidated group, carried forward tax losses may transfer along with the company, subject to transfer and utilization rules.

Where an Australian target company has carried forward tax losses, these generally continue to be available for recoupment only if there is greater than 50 percent continuity (with respect to dividends, capital and voting rights) in the beneficial ownership of the company. If this primary test is failed, as is usually the case in a takeover, the pre-acquisition losses are available for recoupment only if the Australian company, at all times during the year of recoupment, carries on the same business as it did immediately before the change in beneficial ownership of its shares. This test is difficult to pass because it requires more than mere similarity in the businesses carried on. Its effect is that no new types of businesses or transactions may be entered into without the likely forfeiture of the losses, particularly in the case of a tax-consolidated group. Note, however, that the Australian government has proposed changes to the same-business test whereby, under the new arrangement, the current same-business test will be relaxed to allow businesses to access past-year losses when they have entered into new transactions or business activities.

However, provided the transfer tests are satisfied, same business losses may be refreshed on acquisition by a tax-consolidated group. Given the potential uncertainty in this area, often a ruling is obtained from the tax authorities to confirm that the same-business test has historically been satisfied.

Similarly, no deduction for bad debts is available to the Australian company after its acquisition by the foreign entity unless there is either:

- more than 50 percent continuity of ownership in relation to the year the deduction is claimed and the year the debt was incurred, or
- continuity of the same business at relevant times.

In addition, when the target company becomes a member of the purchaser's tax-consolidated group as a result of the transaction, the tax attributes of the company are transferred to the head company of the consolidated group (i.e. tax losses, net capital losses, franking credits and foreign tax credits). Broadly, these losses may be transferable to the acquirer where the target has satisfied the modified same-business test for the 12 months prior

to the acquisition. Limitation-of-loss rules restrict the rate at which such losses can be deducted against the taxable income of the consolidated group, based on the market value of the loss-making company as a proportion of the market value of the consolidated group as a whole. This is often a complex area.

By contrast, where the target company is a subsidiary member of an Australian tax-consolidated group, the tax attributes of the company leaving the tax-consolidated group are retained by the head company of the tax-consolidated group and do not pass to the purchaser with the entity transferred.

Crystallization of tax charges

Under the self-assessment tax regime, the ATO generally is subject to a limited review period of 4 years following the lodgment of the income tax return or business activity statement (except in the case of tax evasion or fraud).

Pre-sale dividend

To prevent pre-sale dividends from being distributed to reduce capital gains arising on sale of shares, the ATO has ruled that a pre-sale dividend paid by a target company to the vendor shareholder is part of the vendor shareholder's capital proceeds for the share disposal (thereby increasing capital gain or reducing capital loss arising on the share sale), if the vendor shareholder has bargained for the dividend in return for selling the shares.

This follows the High Court of Australia decision in *Dick Smith*. In this case, the share acquisition agreement stipulated that a dividend would be declared on shares prior to transfer and the purchaser was to fund the dividend (with the purchase price calculated by deducting the dividend amount). The court found the value of the dividend formed part of the consideration for the dutiable transaction for stamp duty purposes.

In addition, complex anti-avoidance provisions also apply in this area.

GST

GST (VAT) does not apply to the sale of shares. The supply of shares is a 'financial supply' and input taxed if sold by a vendor in Australia to a purchaser in Australia. However, if the shares are sold to, or bought from, a non-resident that is not present in Australia, the sale may be a GST-free supply (i.e. zero rated).

While GST should not apply in either event, the distinction between an input taxed supply and a GST-free supply is important from an input tax credit-recovery perspective. Generally, full credits are not available for GST incurred on costs associated with making input taxed supplies, but full credits should be available for GST-free supplies.

Stamp duty

New South Wales is the only jurisdiction that imposes stamp duty on transfers of unlisted shares and units in unit trust schemes at the marketable securities rate of 60 cents per AUD100 of the greater of the consideration and unencumbered value of the shares or units. New South Wales is scheduled to abolish such duty on 1 July 2016. Stamp duty at the marketable securities rate is not imposed on transfers of listed shares or units.

All states and territories impose land-rich or landholder duty on relevant acquisitions of interests in land-rich or landholder companies and trusts. The tests for whether an entity is land-rich or a landholder differ between the jurisdictions.

In some jurisdictions, landholder duty is also imposed on certain takeovers of listed landholders. Land-rich and landholder duty is imposed at rates up to 5.75 percent of the value of the land (land and goods in some states) held by the landholder. A concessional rate of duty applies to takeovers of listed landholders in some but not all states (the concessional rate is 10 percent of the duty otherwise payable).

The acquirer generally is liable to pay stamp duty, but in some jurisdictions the landholder and acquirer are jointly and severally liable to pay stamp duty.

Tax clearances

It is not possible to obtain a clearance from the ATO by giving assurances that a potential target company has no arrears of tax or advising as to whether or not it is involved in a tax dispute.

Where the target company is a member of an existing tax-consolidated group or GST group, the purchaser should ensure the target company is no longer liable for any outstanding tax liabilities of the existing group (e.g. if the head company of that group defaults). The purchaser should ensure that the target company:

- is party to a valid tax-sharing agreement or indirect tax-sharing agreement with the head company and other members of the existing group, which reasonably limits the target company's exposure to its own standalone tax liabilities
- exits the existing group with no outstanding group liabilities by attaining evidence that the existing company made an exit payment to the head company of the group.

The ATO has a detailed receivables policy that sets out its approach to recovering outstanding group tax liabilities from an exiting company. The purchaser should bear this in mind when assessing the tax position of the target company.

Choice of acquisition vehicle

After the choice between the purchase of shares or assets has been made, the second decision concerns the vehicle to be used to make the acquisition and, as a consequence, the position of the Australian operations in the overall group structure. The following vehicles may be used to acquire the shares or assets of the target:

- foreign company
- Australian branch of the foreign company
- special-purpose foreign subsidiary
- treaty country intermediary
- Australian holding company
- joint venture
- other special purpose vehicle (e.g. partnership, trust or unit trust).

The structural issues in selecting the acquisition vehicle can usually be divided into two categories:

- the choice between a branch or a subsidiary structure for the acquired Australian operations
- whether there are, in the circumstances, advantages to interposing an intermediary company as the head office for the branch or the holding company for the subsidiary.

Local holding company

It is common to interpose an Australian holding company between a foreign company (or third-country subsidiary) and an Australian subsidiary. The Australian holding company may act as a dividend pool because it can receive dividends free of further Australian tax and re-invest these funds in other group-wide operations. It is common to have an Australian holding company act as the head entity of a tax-consolidated group.

Foreign parent company

Where the foreign country of the parent does not tax capital gains, it may wish to make the investment directly. Non-residents are not subject to CGT on the disposal of shares in Australian companies unless the company is considered to have predominantly invested in real property (see earlier). However, while Australian interest WHT is generally 10 percent for treaty and non-treaty countries, the dividend WHT is commonly limited to 15 percent on profits that have not been previously taxed (referred to as 'unfranked' or 'partly franked' dividends; see preserving imputation credits in other considerations below) only when remitted to treaty countries. (Australia's more recent

treaties may reduce this rate further if certain conditions are satisfied.)

The dividend WHT rate is 30 percent for unfranked dividends paid to non-treaty countries. The tax on royalties paid from Australia is commonly limited to 10 percent for treaty countries (30 percent for non-treaty countries). Therefore, an intermediate holding company in a treaty jurisdiction with lower WHT rates may be preferred, particularly if the foreign parent is unable fully to offset the WHT as a foreign tax credit in its home jurisdiction (subject to limitation on benefit clauses in tax treaties and the application of the Australian GAAR).

Non-resident intermediate holding company

If the foreign country imposes tax on capital gains, locating the subsidiary in a third country may be preferable. The third-country subsidiary may also sometimes achieve a WHT advantage if the foreign country does not have a tax treaty with Australia.

Note, however, that some treaties contain anti-treaty shopping rules. As noted, the ATO has ruled in a taxation determination that the Australian domestic GAAR would apply to inward investment private equity structures designed with the dominant purpose of accessing treaty benefits. The taxation determination demonstrates the ATO's enhanced focus on whether investment structures (e.g. the interposition of holding companies in particular countries) have true commercial substance and were not designed primarily for tax benefits.

A key consideration in this regard is to ensure the payee beneficially owns the dividends or royalties. Beneficial entitlement is a requirement in most of Australia's treaties.

Local branch

Forming a branch may not seem to be an option where shares, rather than assets, are acquired, since, in effect, the foreign entity has acquired a subsidiary. However, if the branch structure is desired but the direct acquisition of assets is not possible, the assets of the newly acquired company may be transferred to the foreign company post-acquisition, effectively creating a branch. Great care needs to be taken when creating a branch from a subsidiary in this way, including consideration of the availability of CGT rollover relief, potential stamp duties and the presence of tax losses.

However, a branch is not usually the preferred structure for the Australian operations. Many of the usual advantages of a branch do not exist in Australia:

- There are no capital taxes on introducing new capital either to a branch or to a subsidiary.

- No WHT applies on taxed branch profits remitted to the head office or on dividends paid out of taxed profits (i.e. franked dividends, discussed later in the section on preserving imputation credits) from an Australian subsidiary.
- The profits of an Australian branch of a non-resident company are taxed on a normal assessment basis at the same rate as the profits of a resident company.

The branch structure has one main potential advantage. Where the Australian operations are likely to incur losses, in some countries, these may be offset against domestic profits. However, the foreign acquirer should consider that deductions for royalties and interest paid from branches to the foreign head office, and for foreign exchange gains and losses on transactions between the branch and head office, are much more doubtful than the equivalents for subsidiaries, except where it can be shown that the payments are effectively being made to third parties.

The only provisions that might restrict the deduction for a subsidiary are the arm's length pricing rules applicable to international transactions and the thin capitalization provisions.

Reorganizations and expansions in Australia are usually simpler where an Australian subsidiary is already present.

An Australian subsidiary would probably have a much better local image and profile and gain better access to local finance than a branch. The repatriation of profits may be more flexible for a subsidiary, as it may be achieved either by dividends or by eventual capital gain on sale or liquidation. This can be especially useful where the foreign country tax rate is greater than 30 percent; in such cases, the Australian subsidiary may be able to act as a dividend trap. Finally, although Australian CGT on the sale of the subsidiary's shares might be avoided, this is not possible on the sale of assets by a branch, which is, by definition, a PE.

Two other frequently mentioned advantages of subsidiaries are limited liability (i.e. inaccessibility of the foreign company's funds to the Australian subsidiary's creditors) and possible requirements for less disclosure of foreign operations than in the branch structure. However, both these advantages can also be achieved in Australia through the use of a branch, by interposing a special-purpose subsidiary in the foreign country as the head office of the branch.

Joint venture

Where the acquisition is to be made together with another party, the parties must determine the most appropriate

vehicle for this joint venture. In most cases, a limited liability company is preferred, as it offers the advantages of incorporation (separate legal identity from that of its members) and limited liability (lack of recourse by creditors of the Australian operations to the other resources of the foreign company and the other party). Where the foreign company has, or proposes to have, other Australian operations, its shareholding in the joint venture company is usually held by a separate wholly owned Australian subsidiary, which can be consolidated with the other operations.

It is common for large Australian development projects to be operated as joint ventures, especially in the mining industry. Where the foreign company proposes to make an acquisition in this area, it usually must decide whether to acquire an interest in the joint venture (assets) or one of the shares of the joint ventures (usually, a special-purpose subsidiary). This decision and decisions relating to the structuring of the acquisition can usually be made in accordance with the preceding analysis.

Trusts

Trusts, particularly Australian unit trusts, are popular investment structures in Australia. Under a trust arrangement, the legal owner (the trustee) holds the property 'in trust' for the benefit of the beneficial owners (the unit holders). In essence, the trust separates the legal and beneficial ownership of the property.

Depending on the objectives for entering into the arrangement, trusts can be established in a number of different forms, including discretionary trusts and unit trusts.

In a discretionary trust (or family trust), the beneficiaries do not have a fixed entitlement or interest in the trust funds. The trustee has the discretion to determine which of the beneficiaries are to receive the capital and income of the trust and how much each beneficiary is to receive. The trustee does not have a complete discretion. The trustee can only distribute to beneficiaries within a nominated class as set out in the terms of the trust deed.

A unit trust is a trust in which the trust property is divided into a number of defined shares, or 'units'. The beneficiaries subscribe for the units in much the same way as shareholders in a company subscribe for shares. Some benefits on the use of a unit trust over a discretionary trust and company include:

- clearly defined interest in the asset and income of the trust
- less regulation than a company

- trust deed can be tailored to the needs of the beneficiaries
- no legal issues on the redemption of units by the unit holders
- easier to wind-up than a company.

To the extent an Australian trust's income is sourced in Australia, corresponding distributions to non-resident unit holders are generally subject to WHT. The rate of tax and method of payment depends on whether the income represents:

- Interest: The trust is generally required to withhold tax at 10 percent, which is a final tax.
- Distributions: On distributions made by a flow-through unit trust, the trust is generally required to withhold tax at 30 percent.
- Foreign superannuation funds. These funds are exempt from income tax in their own country and are not subject to Australian interest or dividend WHT.
- MITs: The MIT regime is a concessional WHT regime that is used primarily in Australian real estate investment. The regime's key benefit is that the rate of WHT on distributions of net rental income and capital gains made by the MIT may be as low as 15 percent (or 10 percent if in respect of a 'clean' building) when distributed to residents of 'exchange of information countries' per the Australian tax regulations. An MIT is a unit trust that satisfies certain requirements:
 - The trust must satisfy a widely held ownership requirement and must not be closely held under the applicable tests.
 - A 'substantial proportion' of the 'investment management activities' must be carried out in Australia.
 - The trust must not be carrying on a 'trading business' or control another entity that is carrying on a 'trading business'.

The Australian government is set to establish a new tax system for certain managed investment trusts, called attribution MITs (AMIT). The new tax system will enable the Commissioner of Taxation to:

- determine an amount of non-arm's length income in relation to a MIT
- provide that a member of an AMIT will make a capital gain or capital loss when a CGT event happens to their membership interests

- provide that fund payment withholding provisions apply when a withholding MIT makes a fund payment to another entity that has a place of payment or address outside Australia
- exclude certain superannuation funds and exempt entities from the application of the 20 per cent tracing rule for public trading trusts
- repeal the corporate unit trust rules
- extend the list of entities qualifying as eligible investors for the purpose of the widely held requirements.

The AMIT rules are due to have effect from 1 July 2016, with the option of early adoption from 1 July 2015.

Choice of acquisition funding

Where a purchaser uses an Australian holding company in an acquisition, the form of this investment must be considered. Funding may be by way of debt or equity. A purchaser should be aware that Australia has a codified regime for determining the debt or equity classification of an instrument for tax purposes. This is, broadly, determined on a substance-over-form basis.

In addition, mortgage duty should be considered in the context of debt funding. New South Wales is the only jurisdiction that imposes mortgage duty. To the extent that any debt financing is secured over property wholly or partly in New South Wales (including tangible and intangible assets, bank accounts and shares in a New South Wales company), mortgage duty is payable at 0.4 percent of borrowings multiplied by the proportion of secured property in New South Wales. Mortgage duty is scheduled to be abolished on 1 July 2016.

In the context of equity funding, it will also need to be considered whether the issue of shares or units in a landholder may trigger landholder duty (see comments on landholder duty above).

Debt

Generally, interest is deductible for income tax purposes (subject to commentary below), but dividends are not. Additionally, the non-interest costs incurred in borrowing money for business purposes, such as the costs of underwriting, brokering, legal fees and procurement fees, may be generally written-off and deducted over the lesser of 5 years or the term of the borrowing.

Whether an instrument is debt or equity for tax purposes is a key consideration in implementing a hybrid financing structure, discussed later.

Deductibility of interest

Interest payable on debt financing is generally deductible in Australia, provided the borrowed funds are used in the assessable income-producing activities of the borrower or to fund the capitalization of foreign subsidiaries. No distinction is made between funds used as working capital and funds used to purchase capital assets.

The major exceptions to this general rule are as follows:

- Where the thin capitalization rules are breached, a portion of the interest is not deductible.
- In addition to the quantum of the loan being arm's length under the thin capitalization rules (or within the safe harbor limits), the interest rate on loans must be arm's length in accordance with transfer pricing principles.
- Interest expenses incurred in the production of certain tax-exempt income are not deductible.
- Interest expenses incurred in the holding of a capital asset are not deductible where the only prospective assessable income in Australia is the capital gain potentially available on sale (the interest expenses may be included in the cost base for CGT purposes).

The thin capitalization rules apply to inbound investing entities with respect to all debt that gives rise to tax deductions. These rules deny interest deductions where the average amount of debt of a company exceeds the safe harbor debt amount, the alternative arm's length debt amount and, in certain circumstances, the worldwide debt amount of the company.

The safe harbor debt amount is essentially 60 percent of the value of the assets of the Australian company, which is debt-to-equity ratio of 1.5:1. For financial institutions, this ratio is increased to 16:1. The arm's length debt amount is the amount of debt that the Australian company could reasonably be expected to have borrowed from a commercial lending institution dealing at arm's length.

The thin capitalization rules, subject to additional safe harbors, apply to Australian groups operating overseas (outbound investing entities) in addition to Australian entities that are foreign-controlled and Australian operations of foreign multinationals.

As the thin capitalization rules apply regarding all debt that gives rise to tax deductions, no distinction is made between connected and third-party financing or between local and foreign financing.

Withholding tax on debt

Australia generally imposes WHT at 10 percent on all payments of interest, including amounts in the nature of interest (e.g. deemed interest under hire purchase agreements or discounts on bills of exchange). The 10 percent rate applies to countries whether or not Australia has concluded a tax treaty with the country in question. However, the applicable interest WHT rate may be reduced to 0 percent on certain interest payments to financial institutions by some of Australia's more modern tax treaties (including those with the US, UK, France and Japan). Few techniques to eliminate WHT on interest are available.

Interest paid on widely held debentures issued outside Australia for the purpose of raising a loan outside Australia is exempt from WHT where the interest is paid outside Australia. As Australian WHT cannot usually be avoided, the acquisition should be planned to ensure that credit is available in the country of receipt.

Australia does not impose WHT on franked dividends. Australia imposes WHT on the unfranked part of a dividend at a rate that varies from 15 percent, the usual rate in Australia's treaties, to 30 percent for all non-treaty countries. In the case of the US and UK treaties, the rate of dividend withholding may be as low as 0 percent.

Australia is progressively renegotiating its tax agreements with its preferred trading partners with a view to extending the 0 percent concessional WHT rate.

Checklist for debt funding

- Interest WHT at 10 percent ordinarily applies to cross-border interest, except to banks in the UK and US, unless the interest is paid in relation to a publicly offered debenture.
- Third-party and related-party debt are treated in the same manner for Australian thin capitalization purposes.
- Interest expense in a financing vehicle can be offset against income of the underlying Australian business when it is part of an Australian tax-consolidated group.

Equity

Scrip-for-scrip relief

Equity is another alternative for funding an acquisition. This may take the form of a scrip-for-scrip exchange whereby the seller may be able to defer any gain, although detailed conditions must be satisfied.

The main conditions for rollover relief to be available include:

- All selling shareholders can participate in the scrip-for-scrip exchange on substantially the same terms.
- Under the arrangement, the acquiring entity must become the owner of 80 percent or more of the voting shares in the target company, or the arrangement must be a takeover bid or a scheme of arrangement approved under the Corporations Act 2001.
- The selling shareholders hold their shares in the target company on capital account (i.e. the shares are not trading stock).
- The selling shareholders acquired their original shares in the target company on or after 20 September 1985.
- Apart from the rollover, the selling shareholders would have a capital gain on the disposal of their shares in the target company as a result of the exchange.

Additional conditions apply where both the target company and the purchaser are not widely held companies or where the selling shareholder, target company and purchaser are commonly controlled.

Where the selling shareholders receive only shares from the acquiring company (the replacement shares) in exchange for the shares in the target company (the original shares) and elect for scrip-for-scrip rollover relief, they are not assessed on any capital gain on the disposal of their original shares at the time of the acquisition. Any capital gain on the shares is taxed when they dispose of their replacement shares in the acquiring company. Where the sellers receive both shares and other consideration (e.g. cash), only partial CGT rollover is available. The cost base of the original shares is apportioned on a reasonable basis between the replacement shares and the other consideration, and the selling shareholders are subject to CGT at the time of the share exchange to the extent that the value of the other consideration received exceeds the allocated portion of the original cost base of the original shares.

Where the selling shareholders acquired their original shares prior to 20 September 1985 (pre-CGT shareholders), subject to transitional provisions, the selling shareholders are not subject to CGT on the disposal of the original shares, so they do not require rollover relief. However, such shareholders lose their pre-CGT status, so they are subject to CGT on any increase in the value of the replacement shares between the acquisition and subsequent disposal of the replacement shares. The cost base of the replacement shares that a pre-CGT shareholder receives is the market value of those shares at the time of issue.

Provided the target company or purchaser is a widely held company, the cost base of the shares in the target company that are acquired by the purchaser is the market value of the target company at the date of acquisition. The CGT cost base of the target shares acquired by the purchaser is limited if the selling shareholders' cost base in the target company (i.e. no step-up to market value is available) if:

- the shares are acquired from a substantial shareholder who holds a 30 percent or more interest (together with associates) in the target company
- the shares are acquired from common shareholders in the target company and the purchaser company, who, together with associates, hold an 80 percent or more interest in the target company prior to the acquisition and an 80 percent or more interest in the purchaser after the acquisition, or
- the shares are acquired as part of a 'restructure' under the scrip-for-scrip arrangement rather than a genuine takeover.

Generally, a company is widely held if it has at least 300 members. Special rules prevent a company from being treated as widely held if interests are concentrated in the hands of 20 or fewer individuals.

Demerger relief

Demerger relief rules are also available to companies and trusts where the underlying ownership (at least 80 percent) of the divested membership interests in a company is maintained on a totally proportionate basis. These rules are not available to membership interests held on revenue account. In an M&A context, safeguards in the anti-avoidance provisions prevent demergers from occurring where transactions have been pre-arranged to effect change in control.

The demerger relief available is as follows:

- CGT relief at the shareholder level providing for cost base adjustments between the original and new membership interests
- CGT relief at the corporate level providing for a broad CGT exemption for the transfer or cancellation of membership interests in the demerged entity
- deeming the divestment of shares to shareholders not to be a dividend, subject to anti-avoidance rules.

Dividend imputation rules

Australia operates an imputation system of company taxation through which shareholders of a company gain relief against their own tax liability for taxes paid by the company.

Resident companies must maintain a record of the amount of their franking credits and franking debits to enable them to ascertain the franking account balance at any point in time, particularly when paying dividends. This franking account is a notional account maintained for tax purposes and reflects the amount of company profits that may be distributed as franked dividends.

Detailed rules determine the extent to which a dividend should be regarded as franked. A dividend may be partly franked and partly unfranked. Generally, a dividend is franked where the distributing company has sufficient taxed profits from which to make the dividend payment and the dividend is not sourced from the company's share capital.

Dividends paid to Australian resident shareholders carry an imputation rebate that may reduce the taxes payable on other income received by the shareholder. Additionally, shareholders who are Australian-resident individuals and complying superannuation funds can obtain a refund of excess franking credits.

For non-resident shareholders, however, franked dividends do not result in a rebate or credit, but instead are free of dividend WHT (to the extent to which the dividend is franked).

No dividend WHT is levied on dividends paid by a resident company to its resident shareholders. Income tax assessed to an Australian-resident company generally results in a credit to that company's franking account equivalent to the amount of taxable income less tax paid thereon.

The franking account balance is not affected by changes in the ownership of the Australian company. As non-resident

companies do not obtain franking credits for tax paid, an Australian branch has no franking account or capacity to frank amounts remitted to a head office.

Hybrids

Due to Australia's thin capitalization regime, a purchaser usually finances through a mix of debt and equity and may consider certain hybrid instruments. Australia does not impose stamp duty on the issue of new shares in any state, and there is no capital duty. However, it should be considered whether landholder duty may be triggered on the issue of shares in a landholder.

As noted earlier in this report, the characterization of hybrids (e.g. convertible instruments, preferred equity instruments and other structured securities) as either debt or equity is governed by detailed legislative provisions that have the overriding purpose of aligning tax outcomes to the economic substance of the arrangement.

These provisions contain complex, interrelated tests that, in practice, enable these instruments to be structured such that subtle differences in terms can decisively alter the tax characterization in some cases. Examples of terms that can affect the categorization of an instrument include the term of the instrument, the net present value of the future obligations under the instrument and the degree of contingency/certainty surrounding those obligations.

Additionally, the debt/equity characterization of hybrid instruments under the Australian taxation law and that under foreign taxation regimes have been subject to enhanced scrutiny by the ATO and foreign revenue authorities. The application of an integrity provision that deems an interest from an arrangement that funds a return through connected entities to be an equity interest under certain circumstances (and thus causes returns to be non-deductible) should be considered in this context.

Accordingly, the careful structuring of hybrid instruments is a common focus in Australian business finance. In some cases, this focus extends to cross-border hybrids, which are characterized differently in different jurisdictions.

Discounted securities

Historically, a complex specific statutory regime has applied that, broadly, seeks to tax discounted securities on an accruals basis. This treatment is essentially preserved under the Taxation of Financial Arrangements (TOFA) provisions, which aim to align the tax and accounting treatment of financial arrangements. Note that interest WHT at 10 percent may apply when such a security is transferred for more than its issue price.

Deferred settlement

Where settlement is deferred on an interest-free basis, any CGT liability accruing to the seller continues to be calculated from the original disposal date and on the entire sale proceeds. Furthermore, where interest is payable under the settlement arrangement, it does not form part of the cost base. Rather, it is assessable to the seller and deductible to the purchaser to the extent that the assets or shares are capable of producing assessable income, other than the prospective capital gain on resale. For details on the treatment of earn-outs, see proposed changes earlier in this report.

Concerns of the seller

Non-residents generally are exempt from CGT on the disposal of Australian assets held on capital account, including a disposal of shares in a company or interests in a trust. The key exception is where a non-resident has a direct or indirect interest in real property, which is defined broadly to include leasehold interests, fixtures on land and mining rights. The provisions that seek to apply CGT in these circumstances are extremely broad and carry an extraterritorial application in that non-residents disposing of interests in upstream entities that are not residents of Australia may also be subject to CGT.

The CGT exemption for non-residents does not apply to assets used by a non-resident in carrying on a trade or business wholly or partly at or through a PE in Australia.

The ATO has also historically argued that disposals by overseas private equity funds may have an Australian source and be taxable on revenue account and therefore not benefit from the exemption for non-residents on capital gains on Australian shares.

Where a purchase of assets is contemplated, the seller's main concern is likely to be the CGT liability arising on assets acquired after 19 September 1985. Where the sale is of a whole business or a business segment that was commenced prior to CGT, the seller normally seeks to allocate as much of the price as possible to goodwill. Payment for goodwill in these circumstances is generally free from Australian income tax, unless there has been a majority change in underlying ownership of the assets.

The CGT liability may also be minimized by favorably spreading the overall sale price of the assets in such a way that above-market prices are obtained for pre-CGT assets and below-market prices obtained for post-CGT assets. Such an allocation may be acceptable to the purchaser because it may not substantially alter the CGT on sales.

However, the prices for all assets should be justifiable; otherwise, the ATO may attack the allocation as tax avoidance. The purchaser would also be keen to review the allocation, with particular reference to those assets that have the best prospects for future capital gains.

The seller is concerned about the ability to assess the amount of depreciation recouped where depreciable assets (other than buildings) are sold for more than their tax written-down value.

The excess of consideration over the tax written-down value is included in assessable income in the year of sale as a balancing adjustment and taxed according to the normal income tax rules. Where a depreciable building is sold, no such balancing adjustment is generally made. Where a depreciable asset (other than a building) is sold for less than its tax written-down value, the loss is deductible as a balancing deduction in the year of sale. This balancing deduction is not treated as a capital loss.

Strictly speaking, the seller is also required to include as assessable income the market value of any trading stock sold, even though a different sale price may be specified in the sale agreement. As noted earlier, the ATO's usual practice is to accept the price paid as the market value.

Stamp duty is payable by the purchaser but inevitably affects the price received by the seller.

GST considerations are also relevant to the seller. As noted above, the sale of assets may be a taxable supply unless the sale qualifies as a GST-free supply of a going concern. Where the going concern exemption is not available, the types of assets being transferred need to be considered individually to determine the applicable GST treatment. While the sale and purchase of shares does not attract GST, full input tax credits may not be available for GST incurred on transaction costs associated with the sale or purchase. For some costs, a reduced input tax credit may be available for certain prescribed transaction costs.

Where the seller company has carried forward losses, the sale of business assets does not ordinarily jeopardize its entitlement to recoup those losses. However, the seller company may be relying on satisfaction of the same-business test (see this report's information on using pre-acquisition losses) to recoup the losses (e.g. due to changes in the ownership of the seller since the year(s) of loss). Care is then required, as the sale of substantial business assets could jeopardize satisfaction of this test and lead to forfeiture of the losses.

Where a purchase of shares is contemplated, the seller may have several concerns, depending on the seller's situation. Potential concerns include the following:

- Current or carried forward losses remain with the company, so they are unavailable to the seller where the shares in the company are sold. If the seller currently has an entitlement to such losses without recourse to the same-business test, this entitlement is not forfeited when the business assets are sold and the seller may be able to inject new, profitable business to recoup these losses. However, where the target company is included within the seller's tax-consolidated group prior to sale, the seller retains the tax losses.
- Where the seller acquired all or part of its shareholding after 19 September 1985, the sale of shares has CGT consequences and a capital gain or loss may accrue. Where the acquisition is achieved by way of a share swap, CGT rollover relief may be available. Where the target company forms part of the seller's tax-consolidated group, the seller is treated as if it had disposed of the assets of the target company; any gain is calculated as the excess of the sale proceeds over the tax cost base of the assets (less liabilities) of the target company. Where the liabilities of the target company exceed the tax cost base of the target's assets, a deemed capital gain arises for the seller.
- The purchaser may request indemnities or warranties (usually subject to negotiation).
- Any gain on the sale of pre-CGT shares may also be assessable where the seller is dealing in shares or where the seller purchased the shares either with the intention of sale at a profit or as part of a profit-making endeavor.
- In the case of shares in a private company or interest in a private trust acquired before 19 September 1985, where the value of the underlying assets of a company or trust acquired after 19 September 1985 represents 75 percent or more of the net worth of the company or trust, CGT may be payable.

Company law and accounting

Corporations Act 2001 and IFRS

The Australian Corporations Act 2001 (Corporations Act) governs the types of company that can be formed, ongoing financial reporting and external audit requirements, and the repatriation of earnings (either as dividends or returns of capital).

Australian accounting standards are the equivalent of International Financial Reporting Standards (IFRS). The acquisition of a business, regardless of whether it is structured as a share acquisition or asset acquisition, is accounted for using purchase accounting.

Under purchase accounting, all identifiable assets and liabilities are recognized at their respective fair values on the date that control of the business is obtained. Identifiable assets may include intangible assets that are not recognized on the target's balance sheet. These intangible assets may have limited lives and require amortization. In a business combination, liabilities assumed include contingent liabilities, which are also recognized on the balance sheet at their estimated fair value. The difference between consideration paid (plus the balance of non-controlling interest at acquisition date and the acquisition date fair value of the acquirer's previous interest in the acquire) and the ownership interest in the fair value of acquired net assets represents goodwill. Goodwill is not amortized but is tested for impairment annually. Any negative goodwill is recognized immediately in the income statement.

Transaction costs associated with business combinations occurring in fiscal years commencing on or after 1 July 2009 are expensed as incurred. The reorganization of businesses under the control of the same parent entity is outside the scope of accounting standards. Typically, these restructurings occur at book values, with no change in the carrying value of reported assets and liabilities and no new goodwill. Again, transaction costs associated with these common control transactions are generally expensed as incurred.

Reporting obligations

Generally, all substantial Australian companies have an obligation to file audited financial statements with the Australian Securities and Investments Commission (ASIC). ASIC monitors compliance with the Corporations Act. These financial statements are publicly available. Filing relief may be available for certain registered foreign companies and Australian entities by taking advantage of class order relief granted by ASIC.

Payment of dividends

The payment of dividends by companies to their shareholders is governed by the Corporations Act and the relevant company's constitution in conjunction with the accounting standards and taxation law.

Under the Corporations Act, a company currently cannot pay a dividend to its shareholders unless its assets exceed

its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend. The dividend payment must also be fair and reasonable to shareholders as a whole and must not materially prejudice the company's ability to pay its creditors.

The above requirements replaced the former profits-based test, which provided that a company could only pay a dividend out of profits. Currently, however, there is ambiguity around whether a dividend declared other than out of profits (e.g. by relying on the net assets test only) would constitute an unlawful reduction of capital (as the Corporations Act prescribes a procedure that must be followed in order to effect a capital reduction). As a result, companies need to carefully consider the requirements to ensure all legal requirements are met and avoid dividend traps (i.e. the inability to stream profits to the ultimate shareholder due to insufficient profits and assets within a chain of companies).

The assessment of whether the applicable requirements have been met (including in relation to available profits) for the declaration of a dividend is determined on a standalone, legal-entity-by-legal-entity basis, not the consolidated position of the corporate group. This entity-by-entity assessment requires planning to avoid dividend traps. Appropriate pre-acquisition structuring helps minimize this risk. Australian law does not have a concept of par value for shares. As mentioned above, the Corporations Act prescribes how share capital can be reduced, including restrictions on the redemption of redeemable preference shares.

Other considerations

Group relief/consolidation

Where the purchaser owns other Australian companies and has elected to form an Australian tax-consolidated group, the target company becomes a subsidiary member on acquisition. Only wholly owned subsidiaries can join an Australian tax-consolidated group.

Issues that arise as a result of the tax-consolidation regime with respect to share acquisitions are as follows:

- A principle underlying the tax-consolidation regime is the alignment of the tax value of shares in a company with its assets. On acquisition, it may be possible to obtain a step-up in the tax value of assets of the newly acquired subsidiary when it joins a consolidated group by pushing down the purchase price of the shares to the underlying assets. The acquiring company is effectively treated as purchasing the assets of the target company, including any goodwill reflected as a premium in the share price above the value of the net assets of the company.
- Because the tax basis of a target's CGT assets is reset, the acquiring company can dispose of unwanted CGT assets acquired as part of the acquisition with no tax cost.
- As discussed above, the Australian government has proposed to amend the tax consolidation provisions for the treatment of liabilities brought into a tax-consolidated group by a subsidiary member. The purpose of the proposal is to remove a double benefit than arguably can arise in relation to certain liabilities held by a joining entity that is acquired by a consolidated group. However, if the proposed changes are enacted, an upfront cash tax cost can arise on formation of a tax-consolidated group that may only be recovered over several years (if at all). These changes need to be considered as part of the tax structuring of transactions.
- Each corporate member of a tax-consolidated group or GST group is jointly and severally liable for the tax and GST liabilities of the whole group. As noted above, this liability can be limited where the companies within the group enter into a tax-sharing agreement (or indirect tax-sharing agreement for GST purposes). When acquiring a company that formed part of a tax-consolidated group or GST group, it is important to determine the extent of its exposure for the tax liabilities of its previous group and mechanisms to reduce this exposure.
 - Where an Australian entity is acquired directly by a foreign entity and the foreign entity has other Australian subsidiaries that have formed a tax-consolidated group, there is an irrevocable choice as to whether or not to include the newly acquired Australian entity in the tax-consolidated group. Alternatively, where the Australian entity is acquired by an existing Australian entity that forms part of a tax-consolidated group, the newly acquired Australian entity is automatically included in the existing group. However, a newly acquired Australian entity is not automatically included in an existing GST group.
 - The historical tax expense and cash flow of the target company is no longer a valid indicator for projecting future cash tax payments. The resetting of the tax base in the assets of the company makes tax modeling for the cash outflows more important.

Transfer pricing

Australia has a complex regime for the taxation of international related-party transactions. These provisions specify significant contemporaneous documentation and record-keeping requirements.

The transfer pricing rules focus on determining an arm's length profit allocation and provide the Commissioner of Taxation with broad powers of reconstruction in respect of international related-party dealings.

General anti-avoidance rule

The GAAR (Part IVA) can apply where:

- a taxpayer enters into a scheme
- the taxpayer obtains a tax benefit from the scheme
- the circumstances indicate that the obtaining of that tax benefit was a dominant purpose of one of the parties.

If the GAAR applies to a scheme, the Commissioner may cancel the tax benefit, make compensating adjustments and impose substantial penalties.

Dual residency

Dual residency is unlikely to give rise to any material Australian tax benefits and could significantly increase the complexity of any transaction.

Foreign investments of a local target company

Where an Australian target company holds foreign investments, the question arises as to whether those investments should continue to be held by the Australian target company or whether it would be advantageous for a sister or subsidiary company of the foreign acquirer to hold the foreign investments.

Australia has a comprehensive international tax regime that applies to income derived by controlled foreign companies (CFC). The objective of the regime is to place residents who undertake certain passive or related-party income earning activities offshore on the same tax footing as residents who invest domestically.

Under the current CFC regime, an Australian resident is taxed on certain categories of income derived by a CFC if the taxpayer has an interest in the CFC of 10 percent or more. A CFC is broadly defined as a foreign company that is controlled by a group of not more than five Australian residents whose aggregate controlling interest in the CFC

is not less than 50 percent. However, a company may also be a CFC in certain circumstances where this strict control test is not met but the foreign company effectively is controlled by five or fewer Australian residents.

Taxpayers subject to the current CFC regime must calculate their income by reference to their interest in the CFC. The income is then attributed to the residents holding the interest in the CFC in proportion to their interests in the company — that is, the Australian resident shareholders are subject to tax in Australia on their share of the attributable earnings of the CFC.

Any income of a CFC that has been subjected to foreign or Australian tax can offset that amount with a credit against Australian tax payable. Excess credits may be carried forward for up to 5 income years. The income of a CFC generally is not attributed where the company is predominantly involved in actively earning income.

Given the comprehensive nature of the CFC regime and the few exemptions available, the Australian target company may not be the most tax-efficient vehicle for holding international investments. However, due to a recent series of reforms relating to conduit relief, Australia is now a favorable intermediary holding jurisdiction. In particular, Australia now has broad participation exemption rules that enable dividend income sourced from offshore subsidiaries and capital profits on realization of those subsidiaries to be paid to non-resident shareholders free from domestic income tax or non-resident WHT.

Foreign investment into Australia

Australia has a foreign investment review framework that requires certain proposals by foreign persons to be approved by Australia's Foreign Investment Review Board (FIRB) before they are implemented. The package of legislative reforms that commenced on 1 December 2015 represents the most significant changes to Australia's foreign investment regime since it was introduced over 40 years ago. The primary objectives of the reforms were to provide stronger enforcement and a better-resourced system with clearer rules for foreign investors. Some of the key changes include stricter penalties for contravening the foreign investment framework, new fees on foreign investment applications and the ATO's enlistment in ensuring compliance and enforcement of critical aspects of the regime.

Determining whether an application for approval is required to be made to FIRB depends on a range of factors, which must be carefully assessed case-by-case and include, among other matters, the type of investor, the type of investment, the industry sector in which the investment will be made and the value of the investment.

In order to avoid delays, it is crucial for foreign investors to consider at an early stage of any transaction whether approval under Australia's foreign investment regime will be required.

Comparison of asset and share purchases

Advantages of asset purchases

- Step-up in the tax value of all assets (minor exceptions only).
- A deduction is available for trading stock purchased.
- No previous liabilities of the company are inherited.
- Possible to acquire only part of a business.
- Not subject to takeover legislation (but may be subject to stock exchange listing rules).
- May qualify as a GST-free supply of a going concern.
- May minimize GST leakage on transaction costs.

Disadvantages of asset purchases

- Complexity of renegotiating/transferring supply, employment, technology and other agreements.
- Higher rates of transfer (stamp) duties.

- Benefit of any losses incurred by the target company remains with the seller.
- Need to consider whether the GST going concern exemption is available.

Advantages of share purchases

- Lower capital outlay (purchase net assets only).
- Potential to step-up the tax value of certain assets in a 100 percent acquisition.
- Less complex contractually and likely more attractive to seller.
- May benefit from tax losses of the target company (unless the target company was a member of a tax-consolidated group).
- Lower or no stamp duties payable (if not predominantly land).
- Acquisition of shares should be either input taxed (exempt) or GST-free (zero rated).

Disadvantages of share purchases

- Liable for any claims or previous liabilities of the entity, including joint and several liability for tax debts of seller's consolidated group where no valid tax-sharing agreement exists.
- Target company losses remain with the seller where the target company exits the seller's tax-consolidated group.
- GST leakage may arise on transaction costs if full input tax credits are not available.

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