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TAX CONSIDERATIONS

KPMG

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Amidst all the commercial considerations involved in listing your business, overlooking the associated tax consequences would be unwise.

As always, when approaching any significant business decision, we recommend that you involve your tax advisors during the early planning stages of your initial public offering (IPO) to ensure that you have properly considered all potential tax factors.

Exiting your business via an IPO will require consideration of the following matters:

• Will a restructure be required prior to IPO and, if so, what are the tax consequences of the restructure?
• Have you fully considered the options provided by employee incentive arrangements, and are these appropriately structured?
• What is the most tax-efficient means of exit from the business, and does this dictate that a dividend be paid prior to sale?
• What transaction costs will be incurred in the IPO, and how will these be treated for tax purposes?
• What tax attributes are currently in the business, and how will these be treated going forward after exit?

This chapter provides a broad overview of these key tax considerations for when you decide to go public.

STRUCTURING YOUR EXIT

IS YOUR BUSINESS IPO READY?

One of the first questions that needs to be addressed prior to a public offering is whether a restructure of the existing business is required.

A pre-sale restructuring may be favourable or necessary for several reasons, often to simplify the holding structure for ease of investment and to create an efficient tax structure going forward for incoming shareholders. The business may include assets that you do not wish to sell, such as real estate assets or other businesses that are not proposed to be part of the IPO offering.

Additionally, you may wish to merge with another potential vendor on the basis that the combined businesses may be complementary and/or provide synergies,
and therefore offer a more compelling investor offering.

Examples of restructures that may be undertaken prior to an IPO include the following:

- combining or removing certain subsidiaries and/or businesses from the corporate group prior to the offering
- reorganising the funding injected into the structure (i.e., debt and/or equity)
- transferring any assets to a corporate vehicle from a trust or a partnership
- introducing a new holding entity as the float vehicle
- carving out certain assets from the public offering given the nature of startup businesses.

It will also be important to consider the likely future profile of the group post-IPO. It will be necessary to ensure that the IPO business has sufficient future profits, cash and franking credits from which to pay dividends to the public post-IPO, and that the payment of a pre-IPO dividend does not prejudice the ability of the business to pay franked dividends post-IPO in a manner consistent with what may be disclosed in the prospectus.

WHAT ARE THE TAX IMPLICATIONS OF A RESTRUCTURE?

In relation to a restructure, it will be important to ensure that no adverse tax outcomes accrue, both for you and the business going forward, which may affect its attractiveness to investors.

In many instances, it may be possible to implement the restructure in a way that allows capital gains tax ‘rollover relief’ to be available (e.g., in relation to the exchange of shares in one company for shares in another). This approach may be necessary where it is preferred to have a new holding company to raise capital from the public to acquire the existing business to be listed. Where the share-for-share exchange is structured properly, it should be possible to claim rollover relief. This means that you would not be immediately liable to pay tax when you receive the shares in the listed company (FloatCo). Instead, any tax paid would be deferred to when you sell the shares in FloatCo at a future point in time. The availability of this rollover relief will therefore be important where a continuing shareholding in the IPO business is retained post-IPO.

Similar rollover relief is available for other aspects of business restructures, including, for example, the transfer of assets from trusts and partnerships into corporations.

The Goods and Services Tax (GST) and stamp duty implications of a restructure and eligibility for any concessions would also need to be assessed. For example, the transfer of business assets may be undertaken as a GST free transfer of a going concern, and certain States and Territories in Australia provide for an exemption from stamp duty for the transfer of otherwise dutiable property between related entities.

A restructure does not necessarily just mean a restructure of the financing arrangements or assets. Consider whether the tax function in the business and tax risk management procedures and processes are reasonable and appropriate, or whether these will need to be more sophisticated or rigorous—especially given the increased revenue authority scrutiny that comes with being a public company.

SHOULD YOU TAKE ADVANTAGE OF TAX CONSOLIDATION?

One decision that will need to be made as part of the tax planning process is whether the entities forming the IPO business should form a tax consolidated group.

Generally, for income tax purposes, separate entities are treated as separate standalone taxpayers. However, where a group of entities is all ultimately wholly owned by a single entity (i.e., a single FloatCo), it is possible for the ultimate parent entity to make an election to form a tax consolidated group comprising itself (as head company) and its wholly owned subsidiary entities.
Where such an election is made, it allows the members of the group including the head company to be treated as a single entity for income tax purposes. This approach allows transactions to occur within this tax consolidated group that are generally free from income tax implications and therefore reduce the tax complexities of running a business.

In addition, on formation of a tax consolidated group, the tax bases of the assets will generally be reset because the assets held by subsidiary members of the group are treated as if they were assets held by the head company at the time of group formation. In some cases, this process of resetting the tax cost bases of assets can result in the tax cost base being increased, potentially to market value, thereby enhancing tax depreciation deductions/reducing taxable gains on disposal.

The implications of forming a tax consolidated group are complex and involve other considerations in addition to those discussed (e.g., implications for the availability of tax losses going forward).

Given the complexities, the issues of tax consolidation will need to be considered at an early stage of the IPO planning process. In particular, the calculations required to determine the impact on the tax basis of assets are complex and will have an impact on the financial disclosures in the prospectus, including deferred tax asset and liability balances.

EMPLOYEE INCENTIVE ARRANGEMENTS

When preparing for an IPO, it is important to determine whether the employee incentive arrangements are structured as efficiently as possible. This is especially true for rapidly growing businesses that may lack operating capital. Funding may need to be committed and reinvested into the business itself to shore up a successful venture. Thus, there is an inherent difficulty in meeting the needs of employees to be regularly and fairly remunerated and also ensuring the continued success and expansion of the business.

One way to meet these challenges whilst still satisfactorily remunerating employees is by providing staff with equity in the company. This method of compensation can be an excellent way to align employee and business interests, as well as to provide employees with exposure to potential upswings in the startup’s business expansion. Providing equity to employees through an Employee Share Scheme (ESS) allows a business to do so with effective commercial outcomes for their employees (Figure 1).

HOW DO ESSs WORK?

A business may provide shares or share rights to employees as part of their total remuneration package. This type of remuneration may be provided under an ESS—a type of remuneration plan with a potential for efficient tax outcomes. This section outlines some of the more common arrangements of ESS variants. The tax outcomes for employees depend on their personal circumstances and the design of the ESS, so the following is only a general summary of possible tax outcomes.

Under an ESS, an employee may acquire, for no consideration, either shares in the company or a right to purchase shares in the company at a
predetermined price. The ESS can be developed so that the shares or share rights may be subject to tax in the hands of the employee either at the time of grant or at a later time. Typically, for tax to be deferred until a later time, shares must be subject to a real risk of forfeiture, and share rights must be subject to a genuine disposal restriction. For example, a real risk of forfeiture will exist where the employee forfeits the shares if they voluntarily cease employment within two years of the time of grant. A genuine disposal restriction will exist where the employee is prevented from disposing of their share rights within one year of the time of grant. The requirement for such restrictions allows the company to develop an ESS, which supports employee retention and reward.

Where restrictions apply to defer tax until a later time, shares will typically be subject to tax in the hands of the employee when those restrictions no longer apply. Where the employee has been granted share rights, the employee will typically be subject to tax when the shares that are acquired from the exercise of their rights are no longer subject to any restrictions. The amount that is subject to tax is generally the market value of the shares at that time, and tax can arise even if employees choose not to immediately sell their shares.

The startup concession provides that, where the eligibility criteria outlined in the next section are met, tax is not payable until the employee disposes of the shares. Tax does not arise for the employee when the shares or share rights are granted to the employee, or when restrictions no longer apply to those shares. Instead, any gain or loss on disposal of the shares will be assessed under the capital gains tax regime. In addition to further deferring when taxation occurs, the employee may be eligible for a 50 percent capital gains tax discount where the shares are held for more than 12 months.

**WHAT ARE THE ELIGIBILITY CRITERIA?**

The following general conditions applying to all ESS schemes must be met to qualify for tax deferral:

1. The recipient of the ESS interest must be employed by the company (or its subsidiary).
2. The ESS must relate only to ordinary shares.
3. Integrity rules must not be breached (relevant only for share trading/investment companies).
4. The employee does not hold more than 10 percent of the shares in the company, nor control more than 10 percent of the votes in a general meeting of that company.

For the startup concession specifically, the additional requirements are as follows:

1. The company must be unlisted (i.e., it does not appear on any stock exchange).
2. The company must have been incorporated for less than 10 years.
3. Aggregated annual turnover does not exceed $50 million.
4. The employing company must be an Australia resident company.
5. The employees must hold the ESS interests for at least three years.

For shares, they must be provided at a discount no greater than 15 percent of the market value.

**THE STARTUP ESS CONCESSION**

More generous tax concessions exist for shares or share rights acquired under an ESS of a startup.
For share rights, they must have an exercise price greater than or equal to the market value of an ordinary share in the company at the time of grant.

For a private company, valuing the shares in the company can be a difficult exercise. However, the Australian Taxation Office provides approved valuation methods to make it easier.

DIFFERENCES TO THE STANDARD ESS REQUIREMENTS

Importantly, the interests provided under a startup ESS do not need to be subject to a genuine risk of forfeiture, nor in the case of shares do they need to be offered to 75 percent of eligible full-time employees to qualify for tax deferral.

EXITING THE BUSINESS

Several matters will need to be considered in relation to the actual exit from the business. These include ensuring that the structure for the actual exit under the IPO is as tax efficient as possible and that concessions are claimed where appropriate. For example, a seller who is an individual or trust may be eligible for the 50 percent capital gains tax discount for capital gains on shares that have been held for 12 months or more.

In some cases, a seller may also be eligible for certain small-business concessions that are available in relation to the exit from an investment. For example, this may mean that gains on the sale of the business could be eligible for a 75 percent discount or that gains could be fully exempt from income tax.

Residency is also a relevant consideration in determining the tax outcomes from exit. Generally, non-resident investors are not subject to Australian capital gains tax on the exit from their investment where the investment is not considered taxable Australian property (broadly, when the underlying business assets do not consist principally of Australian real property).

PRE-IPO DIVIDENDS

If the sale group has a store of franking credits for taxes paid, a key exit consideration will also be whether fully franked dividends should be paid prior to exit. Usually, it will be more tax efficient for the vendor to receive fully franked dividends rather than capital gains subject to the 50 percent capital gains tax discount.

However, a range of factors should be considered. First, the company will need to have a store of franking credits from which to pay the dividend. In addition, there will usually need to be sufficient profits from which to pay the dividend, and questions about how dividends will be funded will need to be considered. For example, will dividends be funded from existing cash held by the business, or from capital to be raised from the public in the IPO?

TRANSACTION COSTS

Undertaking an IPO will likely incur significant transaction costs for both the vendor and the business. The income tax deductibility of the full amount of the transaction cost is not often a clear matter and will depend on the entity that has incurred the transaction costs and the nature of the transaction costs incurred.

Transaction costs can be treated in several possible ways:

1. immediate deduction
2. capitalised into the cost base of an asset
3. deductible over time (e.g., business capital expenditure is deductible over five years).

Examples of common transaction costs include tax advisor costs, legal costs, prospectus preparation costs and commissions/fees paid to investment banks. Generally, the treatment of costs will depend on the nature of the costs incurred, including whether they are revenue or capital in nature. A careful review of costs will be required to determine the tax treatment, including the impact of these costs on the financial disclosures in the prospectus.

In addition to the income tax treatment of costs, it will be important to consider the associated
GST recoverability. An input tax credit will only be available for GST incurred on costs relating to the making of an input taxed financial supply where the Financial Acquisitions Threshold (FAT) is not breached.

An entity will have exceeded the FAT if either or both of the following tests apply to a 12-month period (forward-looking or backwards-looking):

- the amount of all the input tax credits to which the entity would be entitled for its financial acquisitions during the 12-month test period would exceed $150,000
- the amount of all the input tax credits to which the entity would be entitled for its financial acquisitions would be more than 10 percent of the total amount of input tax credits to which it would be entitled for all its acquisitions and importations (including the financial acquisitions) during that 12-month period.

It is therefore important to monitor the GST incurred on transaction costs relating to an IPO and monitor the share register to ascertain to what extent shares have been issued to Australian residents and non-residents.

For completeness, we note that where the FAT is breached, a reduced input tax credit of 75 percent may be available in respect of certain specific costs, and partial credits may be available for GST incurred on costs to the extent that any shares are issued to non-residents.
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