Australia

Country M&A Team

Country Leader ~ Mark O'Reilly (Sydney)

Vanessa Crosland

Anthony Klein

Christian Holle

David Pallier

Michael Frazer

Mike Davidson

Norah Seddon

Paul Abbey

Peter Collins

Peter Le Huray

Tony Clemens

Neil Fuller

Name	Designation	Office Tel	Email
Sydney			
Mark O'Reilly	Partner	+61 (2) 8266 2979	mark.oreilly@au.pwc.com
Christian Holle	Partner	+61 (2) 8266 5697	christian.holle@au.pwc.com
David Pallier	Partner	+61 (2) 8266 4700	david.pallier@au.pwc.com
Michael Frazer	Partner	+61 (2) 8266 8448	michael.a.frazer@au.pwc.com
Mike Davidson	Partner	+61 (2) 8266 1813	michael.davidson@au.pwc.com
Norah Seddon	Partner	+61 (2) 8266 5864	norah.seddon@au.pwc.com
Tony Clemens	Partner	+61 (2) 8266 2953	tony.e.clemens@au.pwc.com
Neil Fuller	Partner	+61 (2) 8266 2025	neil.fuller@au.pwc.com
Melbourne			
Vanessa Crosland	Partner	+61 (3) 8603 3374	vanessa.l.crosland@au.pwc.com
Anthony Klein	Partner	+61 (3) 8603 6829	anthony.klein@au.pwc.com
Paul Abbey	Partner	+61 (3) 8603 6733	paul.abbey@au.pwc.com
Peter Collins	Partner	+61 (3) 8603 6247	pete.collins@us.pwc.com
Peter Le Huray	Partner	+61 (3) 8603 6192	peter.le.huray@au.pwc.com

PricewaterhouseCoopers
Sydney – Darling Park Tower 2, 201 Sussex Street, Sydney, New South Wales 2000, Australia
Melbourne – Freshwater Place, 2 Southbank Boulevard, Melbourne, Victoria 3000, Australia

1. Introduction

1.1 General Information on M&A in Australia

This chapter details the main issues that are relevant to both purchasers and sellers on a transfer of ownership of an Australian business or company.

The Australian taxation system continues to undergo significant reform. The Government has launched various taxation initiatives in recent years, including:

- the introduction of a tax consolidation regime;
- the introduction of a simplified imputation system;
- reform of Australia's international tax law; and
- reform of Australia's tax treatment of financial arrangements.

Broadly, the tax consolidation rules allow resident group companies to be treated as a single entity for income tax purposes, with transactions between such group members being disregarded for corporate tax purposes (e.g., payment of dividends and asset transfers).

These initiatives have created a complicated tax landscape for structuring M&A transactions. Particular care needs to be exercised whenever companies join or leave a consolidated group to ensure that tax attributes are known with certainty and that tax liabilities of the group members are properly dealt with. However, there are still many opportunities to structure an M&A transaction in a manner which delivers significant value to both the vendor and purchaser – particularly in terms of capital gains tax (CGT) planning, and optimising funding and repatriation arrangements.

On 12 December 2006, new CGT rules governing a foreign resident's Australian CGT exposure were enacted as part of Australia's international tax law reform. The new rules apply to CGT events (e.g. disposals) on or after 12 December 2006 and have the effect of narrowing a non-resident's CGT exposure to the disposal of Australian real property, business assets of Australian branches and non-portfolio interests (i.e. 10% or more) in interposed entities (including foreign interposed entities) where the value of such interests are wholly or principally attributable to Australian real property. Prior to 12 December 2006 only portfolio interests (i.e. less than 10%) in Australian public companies held by non-residents were exempt from Australian CGT. Accordingly, these changes have had a major impact on the structuring of M&A transactions.

A Bill dealing with the final stages (stages 3 & 4) of reforms to the "Taxation of Financial Arrangements" is expected to be re-introduced into parliament in 2008 by the new Government following the lapse of the original Bill in 2007 as a result of the change of Government. Broadly, under the proposed law, economic gains and losses on certain financial instruments will be taxed on an accruals basis as opposed to a realisation basis. It is proposed that equity interests will be excluded from this regime. The proposed law currently has an elective start date from 1 July 2008 and a general start date from 1 July 2009, however these dates may change. As this new law will have a significant impact on the Australian tax outcomes of funding arrangements for M&A activity, its impact will need to be considered in the structuring of any transaction.

The 2007 Australian Federal Election resulted in a change in Government. Accordingly, any bills or announcements which have been made by the former Government and which have not become legislation (such as the "Taxation of Financial Arrangements Bill" referred to above) will lapse and, therefore, will need to be reintroduced into Parliament in 2008. Accordingly, any Bills referred to in this tax guide will require reintroduction into Parliament and as such their likely enactment date is uncertain.

1.2 Corporate Tax

1.2.1 Income Tax

The corporate tax rate in Australia is currently 30%. Australian resident companies are generally taxed on income derived directly or indirectly from all sources, whether in or out of Australia.

1.2.2 CGT

Capital gains derived by Australian companies are also generally taxed at 30%.

Where an Australian company disposes of shares in a foreign company in which it holds 10% or more of the voting rights in, any resulting capital gain or loss is reduced by a percentage that reflects the degree to which the assets of the foreign company are used in an active business. This percentage is broadly calculated as the level of active foreign assets of the foreign company divided by the foreign company's total assets. Where this "active foreign business asset percentage" is less than 10%, there is no reduction to the capital gain or loss. Where this percentage is greater than 90%, there is no capital gain or loss to the Australian company. If the percentage is between 10% and 90%, the capital gain or loss is reduced by that percentage.

1.2.3 Dividends

To the extent that dividends are paid between resident companies that are members of a tax consolidated group, they will be ignored for calculating Australian taxable income of the group.

Where dividends are not paid within a consolidated group, the dividend will be fully taxable to the recipient company at the corporate tax rate. A "gross up and credit" system applies for franked dividends (i.e. those paid out of previously taxed profits by a company that is resident) received by a company. The dividend is grossed up for the tax paid and the receiving company is entitled to a tax offset.

Unfranked dividends (i.e. paid out of untaxed profits) are fully taxable to the recipient company and no tax credits are available to the recipient company.

Non-portfolio dividends received by a resident company from foreign investments are exempt from tax, regardless of the country of origin of the dividend. To obtain this exemption, the recipient company must own shares (excluding certain finance shares) entitling the shareholder to more than 10% of the voting power in the foreign company.

Australia's conduit foreign income (CFI) regime came into effect on 1 July 2005. It applies to certain unfranked dividends paid out of foreign income which are distributed by Australian resident companies to a foreign parent. Such dividends are exempt from both income tax and dividend withholding tax. Broadly, the exemption applies to dividends paid from the following income:

- certain foreign sourced dividends;
- foreign income and certain capital gains derived through a permanent establishment in a foreign country;
- capital gains from the disposal of shares in a foreign subsidiary not being subject to Australian CGT; and
- foreign income and gains not subject to tax due to foreign tax credits.

1.3 Withholding Tax

1.3.1 Interest, Dividends and Royalties

Interest, dividends and royalties paid to non-residents are subject to Australian withholding tax, which is a final Australian tax for these non-residents. The rates of tax vary depending on whether Australia has a double tax agreement (DTA) with the recipient jurisdiction. In summary, the rates are usually as follows:

	Non Treaty Rate %	Treaty Rate %
Interest	10	10
Royalties	30	10 – 15
Unfranked dividends (paid out of untaxed profits)	30	15
Franked dividends (paid out of taxed profits)	Nil	Nil

It should be noted that some Australian DTAs (such as the treaties with the United States, the United Kingdom, Finland and Norway) feature lower withholding tax rates. Australia has also signed new DTA's with France and Japan featuring lower withholding tax rates, however until these are ratified by both countries the lower rates will not come into effect.

Australia has a significant number of tax DTAs (currently around 47), which cover Australia's largest trading partners.

1.3.2 Fees for Services

Fees for services are not currently subject to withholding tax, provided the payments are not considered to be royalties.

However, foreign resident withholding tax rules have been introduced and apply to Australian sourced payments of a kind prescribed by Regulations paid on or after 1 July 2004 to a foreign resident. One payment that has been prescribed by Regulation is a payment to foreign residents in respect of a contract for the construction, installation and upgrading of buildings, plant and fixtures and for associated activities. The rate of withholding tax for these payments is 5%.

1.4 Goods and Services Tax (GST)

There are three types of supplies for GST purposes:

- Taxable supplies, where the supplier charges GST on the supply and is entitled to claim input tax credits on its acquisitions relating to those taxable supplies;
- GST-free supplies, where the supplier does not charge GST on the supply and is entitled to claim input tax credits on its acquisitions relating to those GST-free supplies (an example of a GST-free supply is transfer of a "going concern" or a supply to a non-resident); and
- Input taxed supplies, where the supplier does not charge GST on the supply and is not entitled to claim input tax credits on its acquisitions relating to those input taxed supplies.

The GST rate is currently 10%. However, certain transactions such as transfer of shares are input taxed supplies. In addition, a transfer of a business which satisfied certain conditions may be GST-free.

1.5 Stamp Duty

Stamp duty is a State-based tax on transactions and documents. Duty is payable on certain transactions, such as transfers of "dutiable property". In general, "dutiable property" includes land and interests in land (e.g. fixtures, buildings, and leasehold interests), goodwill, intellectual property, plant and equipment, shares. Duty is imposed at rates of up to 6.75% on the greater of the unencumbered value of the dutiable property, or the consideration paid. A transfer of shares is subject to duty at the rate of 0.6% in some States. However, higher rates of duty apply to dealings in shares in "land rich" entities. Secured financing also attract a separate rate of duty.

Whilst Australia has moved toward a consolidated group tax regime, it is important to note that intra-group transactions may still be liable to stamp duty, even if there are no income tax implications for the transactions.

As the stamp duty rules vary in each Australian jurisdiction, the stamp duty position on each transaction should be confirmed.

Duty law is constantly changing and we expect significant new rules to be introduced shortly after this publication.

1.6 Other Relevant Taxes

1.6.1 Branch Profits Tax

There are currently no taxes on the remittance of branch profits to the foreign parent. However, Australia has a peculiar law which seeks to levy tax on dividends paid by non-residents which are sourced from Australian profits. This means that if a foreign company on-pays Australian branch profits to its foreign shareholders as a dividend, the shareholder is technically liable to Australian tax (which may be limited under an applicable DTA). However, in practice the Australian Taxation Office (ATO) has encountered jurisdictional difficulties in collecting this liability.

1.6.2 Other Taxes

Other taxes include:

- fringe benefits tax (a tax on the employer) at 46.5% applicable to the grossed up value of certain non-cash benefits provided to employees;
- payroll tax (a State-based tax) paid by employers; and
- land tax (a State-based tax) paid by the owners of real property.

1.7 Foreign Investment Review Board

Foreign investors are required to obtain approval from the Foreign Investment Review Board for certain investments into Australia. In summary, the types of proposals requiring prior approval, and therefore should be notified to the Government, include, amongst others:

- acquisitions of substantial interests in Australian businesses and companies, where the value of its gross assets exceeds $100 million;
- proposals to establish new businesses involving a total investment of $10 million or more;
- portfolio investments in the media of 5 per cent or more and all non portfolio investments irrespective of size;
- certain takeovers of offshore companies. There are complicated threshold rules relating to offshore companies, with the thresholds varying from either $100 million or $200 million, depending on the composition / percentage of Australian assets compared to its total assets;

- direct investments by foreign governments and their agencies irrespective of size; and
- acquisitions of certain interests in urban land.

Broadly, less stringent rules apply to certain direct and indirect investments (e.g. through an acquisition of an Asian holding company) made by US investors (as defined) into Australia. These include:

- higher thresholds for acquisition of substantial interests in Australian businesses and companies;
- proposals to establish new businesses do not require notification (except by entities controlled by the US government); and
- higher thresholds for takeovers of offshore companies.

2. Acquisitions

2.1 The Preference of Purchasers: Stock v. Assets Deal

Whether a deal is structured as a stock (share) deal or acquisition of assets is typically driven by commercial considerations. Traditionally, there has been a preference in Australia for purchasers to acquire assets rather than shares, although sellers typically preferred to sell shares.

However, as a result of Australia's tax consolidation regime and other reforms, the differences between the tax treatment of an acquisition of assets versus a share deal have narrowed, such that a purchaser may not have a distinct preference for one over the other.

The acquisition of assets traditionally had a number of advantages over the acquisition of shares, including:

- freedom from any exposure to undisclosed tax liabilities;
- the tax effective allocation of purchase price, which may enable a step up in basis for depreciable assets and deductions for trading stock;
- valuable trademarks or other intangibles may be acquired and located outside Australia. In the absence of deductions being available in Australia for the amortisation of certain intangibles, this enables the licensing of the intangible to the Australian company, thereby generating allowable deductions to reduce the overall level of Australian tax; and
- providing an opportunity for tax effective employee termination payments.

Disadvantages of an asset purchase include that tax attributes (including losses and franking credits) of the vendor do not flow to the purchaser, and generally stamp duty on the acquisition of a business can be as high as 6.75%. This is significantly higher than the stamp duty on a private company share purchase (generally 0.6%, assuming that the company is not "land-rich", although some States no longer impose stamp duty on the transfer of shares in non-land rich private companies).

A non-resident buyer should consider a structure which takes into account future exit and repatriation plans and, where applicable, a push-down of debt into Australia as part of the acquisition. Tax effective funding structures may also be available depending upon the home jurisdiction. Acquiring shares in exchange for scrip may enable a merger without cashflow constraints. These points are all addressed in further detail throughout this chapter.

2.2 Stock Acquisition

2.2.1 Acquisition Structure

A non-resident buyer may be concerned with structuring a share acquisition to avoid CGT on future disposals.

With the introduction of the new CGT rules, non-residents are able to exit certain investments in Australia without being taxed on the capital gains made on those investments. Broadly, these investments include non-portfolio interests (held on capital account by a non-resident) directly in an Australian resident company which has a value that is not "wholly or principally" attributable to real property.

For companies holding shares on revenue account, which are not able to access the above CGT exemption, profits on the disposal of shares in an Australian company may be regarded as Australian sourced ordinary income and taxed at the corporate tax rate.

However, if the foreign company is resident in a country with which Australia has a DTA, relief under the business profits article may be available.

2.2.2 Basis Step-Up

A step-up in the tax basis of certain assets of the acquired company or group can be achieved under the tax consolidation regime, where the target company or group is acquired by an Australian tax consolidated group. Very broadly, the amount paid for the shares of the target company or group is "pushed down" to the tax basis of assets of the acquired company or group.

The benefits of obtaining step-up in the tax base of assets are:

- increased depreciation deductions (for depreciable assets); and
- reduced capital gains on the subsequent sale of a CGT asset.

On 12 October 2007, the former Government announced that it planned to modify the tax consolidation regime such that the step-up in the tax cost of a company's assets would not be allowed when an entity joins a tax consolidated group following a CGT rollover affecting the membership interests of the joining entity. The new Government plans to introduce these measures, however has indicated that they would not apply to "non-contrived commercial takeovers". This may have a significant impact on the structuring of acquisitions, particularly those which involve the acquisition of a group of related companies where it is proposed that some of the assets would be sold shortly after acquisition.

As there is currently no draft law which exists in respect of this announcement, there is significant uncertainty surrounding the tax outcomes of scrip for scrip transactions.

2.2.3 Tax Losses

Once there has been a change in the ultimate beneficial ownership of a company of 50% or more, carry forward losses may only be utilised if the company carries on the same business following the change in ownership. This continuity of ownership test (COT) is complex to administer because of the requirement to trace beneficial ownership, although there are tracing concessions available for "widely held companies". A requirement that only those same shares that are held during the test period by the same person can be taken into account in the numerator means that capital injections after the loss year may be problematic.

The SBT is facts and circumstances specific. The ATO has strictly interpreted what constitutes the "same business". In addition, the tax consolidation regime will now make it even harder for consolidated groups to carry forward tax losses after a change in ownership since any new business acquisition will not be able to be easily quarantined from the group.

The above mentioned rules also generally apply to unrealised losses of a company, the quantum of such unrealised losses being determined at the date of COT failure. The "push down" of the acquisition price under the tax consolidation regime will generally eliminate the application of these unrealised rules until there is a subsequent failure of the COT.

2.2.4 Tax Incentives

Depending on the nature and size of the investment project, State governments have given rebates from payroll tax, stamp duty and land tax on an ad hoc basis and for limited periods.

The major tax incentives / grants provided in Australia are outlined in Section 12 below.

2.3 Asset Acquisition

2.3.1 Acquisition Structure

Similar structuring issues apply to the acquisition of assets as for shares.

If the assets are held directly by an offshore entity, the assets will nevertheless form part of the Australian CGT net in relation to future disposals of Taxable Australian Property ("TAP"). In the context of an asset acquisition, TAP assets would broadly include real property situated in Australia and assets used in carrying on a business through a permanent establishment in Australia. Accordingly, setting up through a foreign holding jurisdiction to minimise CGT on exit continues to be relevant in the context of an asset acquisition where the asset falls into one of the categories above.

With the introduction of the new CGT rules exempting non-residents from CGT on the sale of non-portfolio interests in Australian companies (where the value of the company is not "wholly or principally" attributable to real property situated in Australia), an asset acquisition may be less attractive than a share deal for a foreign seller.

2.3.2 Cost Base Step-Up

Where parties are dealing at arm's length, the basis of acquired assets will be the market price negotiated between them. A buyer will typically try to allocate purchase price to depreciable assets rather than goodwill in order to maximise deductions post-acquisition (there is no tax amortisation of goodwill in Australia).

There are more aggressive techniques available to step-up the cost base of an asset to market value prior to sale, but due consideration should be given to Australia's general anti-tax avoidance rules.

Non-deductible expenses of acquisition or sale of an asset may typically be included in the cost base of that asset.

2.3.3 Treatment of Goodwill

Under current taxation laws, there are no deductions available for the acquisition of goodwill.

The capital allowance provisions provide for amortisation deductions for certain types of intangible property. While this will not extend to goodwill, a purchaser should focus on identifying the value of specific intangibles (which may be eligible for amortisation deductions) rather than treating all intangibles as goodwill. For example, allocating purchase price to copyright, patents or industrial designs (or a licence in respect of any such item) could result in obtaining amortisation deductions.

2.4 Transaction Costs

The following sections summarise the GST and stamp duty costs associated with a transaction, as well as the tax deductibility of these and other transaction costs.

2.4.1 GST

a. Acquisition of Shares

The supply of shares by an Australian entity to an Australian counter-party is an input taxed financial supply and no GST is due on the supply of those shares. However, under Australian law, the acquisition of the shares by a company will also be regarded as a financial supply by that company.

In these circumstances, the company acquiring the shares will be unable to claim all the GST charged to it on expenses relating to the acquisition of the shares if the company exceeds the Financial Acquisitions Threshold ("FAT") (a company breaches the FAT if the acquisitions that are made for the purpose of making financial supplies exceeded either $50,000 or 10% of the entities totals input tax credits in any twelve month period).

Nevertheless, in some circumstances, a company that makes input taxed financial supplies may be entitled to claim 75% of the GST incurred on an acquisition as a reduced input tax credit ("RITC"), where it qualifies for a Reduced Credit Acquisition ("RCA").

b. Acquisition of Assets

Where assets transferred are "all things necessary" for the continued operation of a business are transferred, the supply of those business assets may be a transfer of a "going concern" (provided that certain conditions are met) and will be GST-free. In these circumstances, the company acquiring the assets of the business will not be required to pay GST on the supply.

Alternatively, where insufficient assets to continue to operate a business are transferred, the requirements for the "going concern" provisions will not be met and the liability of supplies will depend on the GST liability of the individual assets.

In relation to the GST costs incurred by the company acquiring the assets (including any GST incurred on the actual acquisition of the assets), GST input tax credits (i.e. the GST amount is refunded to or offset against any GST owed by the acquirer) will be available where the assets purchased are used by the acquiring company for a creditable purpose. GST input tax credits may not be available where the acquiring company intends to make input taxed supplies. Adjustment of input tax credits claimed initially may be required if the company later commences making input taxed supplies.

2.4.2 Stamp Duty

2.4.2.1 Acquisition of Stock

Broadly speaking, where there is a transfer of shares in a NSW, South Australia or ACT registered company, stamp duty will be imposed at the rate of 0.6%, calculated on the greater of the unencumbered value of the shares or the consideration paid for the shares. Victoria, Western Australia and Tasmania have abolished share transfer duty.

If the company directly or indirectly (through downstream entities) owns land (e.g. buildings, fixtures and interests in land such as leasehold interests), the land-rich rules need to be considered. Land-rich duty is imposed at rates of up to 6.75% on the value of land deemed to be acquired.

Further, corporate trustee rules need to be considered if the target company is a trustee of a discretionary trust (or owns shares in a company that is a trustee of a discretionary trust).

It should be noted that the land-rich and corporate trustee rules may apply to any transfer of shares, regardless of where the company is registered.

2.4.2.2 Acquisition of Assets

Whether the acquisition of assets / property will be liable to duty will depend upon the types of assets / property being transferred and their location. Where there is a transfer of a business, the transfer of land, goods, goodwill and intellectual property, amongst other things, is subject to duty. If there is no transfer of a business (i.e. there is no goodwill), some categories of property may not be dutiable in certain jurisdictions.

The rate of duty varies between jurisdictions and can be as high as 6.75% on the greater of the consideration paid or the unencumbered value of the property being transferred. The consideration payable for stamp duty purposes may include non-cash amounts such as an assumption of liabilities.

2.4.3 Concessions Relating to M&A

Australian income tax, GST and stamp duty law offer some concessions when a company is being reorganised.

2.4.3.1 Income Tax

Where assets are transferred within a tax consolidated group, the transaction is ignored for Australian income tax purposes. However, stamp duty may still apply to transfers of dutiable property even if the transfer occurs within a tax consolidated group.

2.4.3.2 GST

The GST "going concern" concession is discussed above.

Eligible companies may also form a GST group, with the effect that transfers of assets (or shares) within the GST group are disregarded. However, stamp duty may still apply to transfers of dutiable property even if the transfer occurs within a GST group.

2.4.3.3 Stamp Duty

Exemptions from stamp duty are available for certain qualifying reorganisations in some States. These exemptions typically feature a "clawback" provision, which seeks to enforce the stamp duty liability where certain transactions subsequently occur (such as a subsequent sale of particular assets or entities).

2.4.4 Tax Deductibility of Transaction Costs

Acquisition expenses (including stamp duty) are typically non-deductible, but form part of the capital cost base for calculating the gain or loss on future disposals and in some cases for calculating depreciation on depreciable assets.

However, certain capital expenditure costs incurred in relation to an existing, past or prospective business may be deductible over five years. To be eligible for this deduction a taxpayer must incur the costs in connection with a business conducted for a taxable purpose (i.e. for the purpose of deriving income that is subject to Australian tax on an assessment basis) and this cost must not be otherwise deductible under any other provision of the Act.

Costs of borrowing money are deductible over five years, or over the life of the loan if shorter than five years. The return provided to the financier (such as an amount of interest) is not a borrowing cost and is deductible as mentioned in Section 4.2 below.

A specific deduction is available for costs incurred in obtaining tax advice.

3. Basis of Taxation Following Stock or Asset Acquisition

3.1 Stock Acquisition

A stock acquisition can result in a step-up in the tax basis of assets of the acquired company or group of companies where:

- the resulting group of companies elects to form a tax consolidated group for the first time;
- the acquirer of a company is a tax consolidated group; or
- the acquirer of a group of companies is a tax consolidated group.

The specific treatment of common types of acquired assets are considered in Section 3.2 "Asset Acquisition" below.

3.2 Asset Acquisition

Where parties are dealing at arm's length, the cost base of an asset will be the market price negotiated between them. A buyer will typically try to allocate the purchase price to depreciable assets rather than goodwill, in order to step up the cost base and maximise deductions post-acquisition.

There are more aggressive techniques available to step-up the cost base of an asset to market value prior to sale, but these must have due consideration to Australia's general anti-tax avoidance rules.

The cost of plant and equipment used as part of a business is generally tax depreciable over the useful life using either a diminishing value or straight line method. Amounts paid for computer software may also be tax depreciable.

Companies are able to deduct tax amortisation amounts for certain types of intellectual property (copyright, patents and industrial designs). However, no tax deduction is available in Australia for goodwill.

Non-deductible expenses of acquisition or sale may typically be included in the cost base of an asset.

4. Financing of Acquisitions

4.1 Thin Capitalisation and Debt / Equity Distinction

4.1.1 Thin Capitalisation

Australia has a thin capitalisation regime which potentially restricts the amount of tax deductible interest (or like costs) which any multinational (whether Australian or foreign based) may allocate to its Australian operations. Allied to this measure was a re-draft of the tax distinction between debt and equity.

Broadly, the thin capitalisation rules apply to outbound investors (i.e. Australian entities with controlled foreign investments) and also to inbound investors (i.e. non residents with assets in Australia and also foreign controlled Australian residents).

Importantly, the rules limit tax deductions for costs incurred in respect of debt interests (deductible debt) issued by the taxpayer. The rules apply to all debt interests, both related party and non-related party. Typically the cost will be interest on monies borrowed.

Generally a “safe harbour” level of total debt of 75% of net Australian assets (excluding the deductible debt itself and with certain adjustments) is available. A higher ratio is allowed for certain financial entities. An alternative arm’s length test requires the taxpayer to demonstrate that, having regard to certain factors and assumptions, the actual debt level could have been obtained from an independent lender. One of the assumptions is that any credit support actually provided is to be ignored but not so that actual terms and conditions applying to the actual debt. These factors and assumptions make the arm’s length test difficult to apply. A further test for solely outbound investors is available and allows debt to be calculated by reference to the actual debt of the worldwide group of which the entity is a part.

Modified rules apply to (non-bank) financial institutions, Australian banks and Australian branches of foreign banks.

4.1.2 Debt / Equity Distinction

There are statutory tests to characterise instruments as debt or equity for tax purposes. Distributions may have different tax implications depending on the classification of the underlying instrument.

The distinction between debt and equity is based on a “substance over form” approach. This means that in some circumstances, legal form debt may be treated as equity, and legal form equity may be treated as debt for Australian tax purposes.

Generally, under these rules, an instrument will be classified as debt, rather than equity, if there is an effectively non-contingent obligation for the issuer to return the initial outlay (i.e. the original investment) to the investor. This calculation is based on nominal values for arrangements which must end within 10 years, else present values are used. In general terms, returns on instruments classified as debt are deductible although a deduction cap may apply for certain instruments. A return on debt may not be franked. Returns on debt instruments are also treated as interest for withholding tax purposes. It is possible for redeemable shares with a less than 10 year term to be structured as debt.

An equity interest will generally be characterised by returns that are contingent on the economic performance i.e. profitability of the issuer or part of the issuer’s activities. Returns on equity are non-deductible but generally may be franked. Returns on equity instruments are also treated as dividends for withholding tax purposes.

Under these rules, hybrid (part debt / part equity) instruments will be classified as either all debt or all equity. If an instrument satisfies both the debt and equity test it will be classified as debt.

Following the introduction of these new rules, particular care will need to be taken when considering how the acquisition of Australian assets will be funded. For example, where the acquisition is to be partly funded by shareholder loans, there is a risk that the related arrangement provisions may apply to deem the shareholder loans to be a non-share equity interest. Unforeseen tax consequences may therefore result in the absence of any planning.

4.2 Deductibility of Interest (and similar costs)

Interest costs on debt interest loans and other costs incurred in obtaining or maintaining a debt interest ("debt deductions") are generally deductible in Australia where, ignoring any specific provision which may apply to deny, limit or spread deductibility, the underlying debt is used in producing income which is taxable in Australia.

In addition, deductions for these debt interest costs may be available to Australian residents where the costs are incurred in earning "non-assessable non-exempt" foreign income (e.g. in the case of an Australian resident company certain non-portfolio dividends from foreign countries).

Expenses associated with the derivation of exempt foreign branch income by an Australian company are, however, not deductible.

4.2.1 Stock Deal

4.2.1.1 Funding Cost

Purchasers will typically use a mixture of debt and equity to fund an acquisition and the activities of the target. For non-residents, maximising debt in the Australian target has several advantages. Interest paid offshore is only subject to 10% withholding tax, but is generally deductible in Australia at 30% (subject to thin capitalisation constraints). General comments on deductibility of interest are set out in Section 4.2 above. Repayment of debt principal is also an effective method of repatriating surplus cash without a withholding tax or CGT cost.

With the introduction of the consolidation regime, acquisition structuring has become simpler with intra-group dividends (i.e. within the Australian consolidated group being ignored for tax purposes). This simplifies the repatriation of cash from operating companies to holding companies in the Australian group to service debt commitments.

4.2.1.2 Acquisition Expenses

Acquisition expenses (including stamp duty) are typically non-deductible, but form part of the capital cost base for calculating gain or loss on future disposals.

However, certain capital costs that would not otherwise be deductible under any other provision of the Act may be claimed for tax purposes over 5 years. These include capital expenditure incurred in relation to an existing, past or prospective business. These costs must be incurred in connection with a business conducted for a taxable purpose (i.e. incurred for the purpose of deriving income that is subject to Australian tax on an assessment basis).

Accordingly, capital costs incurred in acquiring interests in Australian companies would thus not be deductible to a non resident as income derived by non-residents from their Australian investments will not be subject to Australian tax.

Borrowing costs are deductible over five years, or over the life of the loan if this is shorter than five years. The return provided to the financier (such as an amount of interest) is not a borrowing cost and is deductible as mentioned in Section 4.2 above.

4.2.2 Asset Deal

4.2.2.1 Debt Deductions

Debt deductions (being costs of obtaining or maintaining debt interests) are typically deductible, subject to thin capitalisation constraints.

The deductibility of other borrowing costs is referred to in Section 2.4.4.

4.2.2.2 Acquisition Expense

See comments on “Acquisition Expenses” in Section 4.2.1.2 above.

5. Mergers

There is no legal concept of a merger in Australia as it exists in other countries. The effect of a merger can be achieved by acquiring the target company and then liquidating that company and transferring its assets to the acquisition vehicle.

This can generally be achieved without any income tax or CGT, where the target company becomes a member of the consolidated group. However, the transfer of property from the target company to the acquisition company may be subject to stamp duty. Various exemptions from such stamp duty exist in some States, and therefore the ultimate stamp duty liability will depend on the location of the assets.

A cross-border merger can also be achieved in a similar way, though the relief from income tax, CGT and stamp duty is not likely to be available and therefore there will be a more significant tax cost.

6. Other Structuring and Post Deal Issues

6.1 Repatriation of Profits

6.1.1 Taxation of Dividends

To the extent that dividends are paid between companies that are members of a tax consolidated group, they will be ignored for calculating Australian taxable income of the group.

Where dividends are not paid within a consolidated group, the dividend will be fully taxable to the recipient company at the corporate tax rate. A “gross up and credit” system applies for franked dividends (i.e. those dividends paid out of previously taxed profits) received by a company. The dividend is grossed up for the tax paid and the company is entitled to a tax offset against tax assessed.

Where an unfranked dividend is paid (i.e. paid out of untaxed profits), the dividend is fully taxable to the recipient company and the company will not be entitled to a tax offset.

Non-portfolio dividends received by an Australian company from foreign investments are exempt from tax, regardless of the country of origin of the dividend. The recipient company must own shares (excluding certain finance shares) entitling the shareholder to more than 10% of the voting power in the foreign company to obtain this exemption.

Dividends paid to offshore investors are subject to withholding tax unless they are franked (i.e. paid from after tax profits). Dividend withholding tax is imposed at a rate of 30% unless a lower rate is available under a DTA (refer section 1.3).

Australia has a new conduit regime for foreign sourced dividends flowing through Australian companies to a foreign parent. The new conduit foreign income (CFI) rules exempt from income tax and dividend withholding tax, unfranked dividends paid from the following income:

- certain foreign sourced dividends;
- foreign income and certain capital gains derived through a permanent establishment in a foreign country;
- capital gains from the disposal of shares in a foreign subsidiary not being subject to Australian CGT; and
- foreign income and gains not subject to tax due to foreign tax credits.

These rules were effective from 1 July 2005.

6.1.2 Interest and Royalties

Interest and royalties are common and efficient methods of repatriating profits, because they are typically deductible in Australia. The withholding tax cost is usually lower than the corporate tax saved.

Strategies to repatriate profits using interest or royalties will need to take into account thin capitalisation constraints for interest, and transfer pricing provisions generally. Australia’s transfer pricing regime is broadly consistent with OECD guidelines, but comparatively strict and effectively policed by the ATO.

Interest withholding tax is imposed at a rate of 10%, with royalty withholding tax being imposed at 30% (unless a lower rate is available under a DTA).

6.1.3 Capital Return

A capital return on shares is generally not assessable to a non-resident where the shares in question do not cease to exist, although the distribution of capital will cause a reduction in basis of the shares in the Australian entity for CGT purposes. To the extent the distribution exceeds the cost base (excluding certain finance shares) entitling the shareholder to, a capital gain will occur. However, the TARP rules (described in 7.2.1.1), may operate to disregard this capital gain for non-residents receiving such a return.

However a capital return can be treated as a dividend under specific anti streaming rules which may apply where generally, capital is returned to the shareholder on the basis that the capital has effectively been replaced by retained profits. In practice it is common to request a ruling from the ATO before making a capital return. A capital return treated as a dividend may be subject to dividend withholding tax.

Share buy-backs can also be an effective method to return capital, although a deemed dividend component would often arise.

6.1.4 Government Approval Requirements

Australia requires each currency transaction over $10,000, including international telegraphic and electronic transfers, to be reported to the Australian Transaction Reports and Analysis Centre. However, this is not an approval requirement, but merely a notification issue.

6.1.5 Repatriation of Profits in an Asset Deal

If the assets are acquired directly by the foreign entity (i.e. through an Australian branch), no branch profits tax will apply on cash paid offshore. Refer to section 1.6.1 which refers to the taxation of Australian sourced profits.

Assets acquired by an Australian acquisition entity will have similar repatriation issues as described above for shares.

6.2 Losses

6.2.1 Tax Losses, Capital Losses and Foreign Losses

Tax losses can be carried forward indefinitely, although they may not be carried back. However, utilisation of these carried forward losses is subject to satisfying the continuity of ownership test (COT) or Same Business Test (SBT). Section 2.2.3 above deals with these issues. Complex rules apply to losses carried forward by trusts.

Under the tax consolidation regime, subject to satisfying the COT or SBT at the joining time, losses of a new group member may be transferred into a consolidated tax group. Losses transferred into a consolidated group may have additional restrictions imposed on the rate at which they may be used.

Capital losses may only be used to offset capital gains. Capital losses may be carried forward (but not carried back) indefinitely, subject to the COT and SBT requirements, as for tax losses (i.e. losses on revenue account).

Broadly, foreign losses may be used to offset foreign income which is assessable to an Australian resident company. Prior to 1 July 2008, the foreign loss rules required foreign losses to be quarantined into four separate classes, only to be used against foreign income of the same class. The new rules, effective on 1 July 2008, have removed this requirement to quarantine amounts enabling a company to combine all of its assessable foreign income amounts when working out a tax offset entitlement.

6.3 Continuity of Tax Incentives

Certain tax incentives may be lost when a business is transferred, particularly where the transfer is in the form of a sale of business assets. The terms of the relevant tax incentive should be reviewed to confirm the availability of the incentive post-deal.

6.4 Group Relief

The tax consolidation regime allows wholly-owned groups of companies, together with eligible trust and partnerships, to consolidate for income tax purposes.

In a tax consolidated group, only the head company is subject to income tax. The head company of a consolidated group may obtain relief with respect to the use of available losses of the group. This relief may relate to losses created by existing companies within the group or joining the group (i.e. losses created before the companies joined are transferred to the group) or losses generated by the head company while within the consolidation regime. Certain restrictions may be placed on the rate at which losses generated by an entity which joins the group, may be used.

Whilst it is only the head company of a consolidated group that is subject to income tax, all members of the group may be jointly and severally liable for the tax in the event of a default unless a proper tax sharing agreement applies. Where a proper tax sharing agreement is in place each member is generally liable for the share of the liability allocated under the agreement. Companies leaving a consolidated group must make a payment to the head company to discharge their obligation under a tax sharing agreement so as to obtain a clear exit from their responsibility to pay tax.

There are no grouping concessions for entities which are not members of a tax consolidated group.

7. Disposals

7.1 The Preference of Seller: Stock v. Assets Deal

A non-resident seller will generally prefer to sell shares rather than assets. This is due to the new CGT exemption available to non-residents holding interests in non land-rich Australian companies.

7.2 Share Disposal

7.2.1 Gain on Sale of Stock

7.2.1.1 Capital Gains Tax

CGT generally applies to the disposal of shares acquired on or after 20 September 1985. Individuals or trusts who have held shares for more than twelve months may be entitled to a 50% CGT discount when calculating their taxable income. The sale of an asset acquired for the purpose of profit making by resale will be taxable as income (subject to any Tax treaty relief). In this case the CGT rules will effectively adjust the capital gain so that there is no double tax i.e. as income and as a capital gain.

A seller's main concern will usually be CGT upon the disposal of its shares. Commercially, a seller may prefer to sell shares so as to not be left with a structure requiring liquidation or ongoing maintenance.

In the case where a shareholder other than an individual makes a capital loss on sale of such interest, the capital loss may be reduced in certain circumstances where the company in which the interest is held (directly or indirectly) was a "loss company".

Changes announced to taxation of capital gains derived by non-residents became effective on 12 December 2006. Broadly, the new rules restrict the application of Australian CGT provisions to non-residents holding direct or indirect interests in Taxable Australian Real Property ("TARP") and the business assets of Australian permanent establishments. Generally, TARP refers to land, leasehold interests in land, and rights to exploit or explore for minerals, oil, gas or other natural resources.

The new provisions also introduce a "long-arm" CGT into the Australian law. Therefore, a non-resident will be subject to CGT on the disposal of a greater than ten per cent ownership interest in an interposed foreign entity, where the value of the interposed entity is wholly or principally attributable to TARP (that is, more than 50 per cent). It is important to note that these changes only apply where the relevant assets are held on capital account. Accordingly, non-residents who hold their investments on revenue account will not benefit from the amendments.

7.2.1.2 Scrip for Scrip CGT Rollover

The "scrip for scrip" provisions provide rollover relief from CGT where an acquirer issues shares to the vendor to acquire a Target Company. This allows a vendor to defer any CGT liability by receiving shares in the acquiring entity as consideration for the transfer. This allows takeovers or "mergers" to occur without an immediate tax liability to the vendor.

To obtain scrip for scrip relief, the acquiring entity must acquire at least 80% of the voting shares in the Target Company and issue scrip in return. The provisions are complex, and in a cross-border context their scope is largely limited to widely held entities.

However, if the previous Government's announcements are enacted, a CGT scrip for scrip rollover may restrict some entities (joining a consolidated group) from obtaining a step-up in tax base of assets (per section 2.2.2).

7.2.1.3 Shareholder Loans

Care needs to be taken when the Target Company has debts due to related parties which are unlikely to be repaid prior to the completion of the sale.

If the debts are simply forgiven, the Australian debt forgiveness rules may operate to deny the future utilisation of certain tax attributes of the Target Company (e.g. carried forward losses – both revenue and capital – and the tax base of certain depreciable and capital assets). Similar issues may arise if the outstanding debt is capitalised.

A commonly adopted alternative is to adjust the final purchase price by the amount of the outstanding debt with the acquirer providing loan funds to the Target Company to enable the debt to be repaid.

7.2.1.4 Unwanted Assets

Assets held by the Target Company which are not to be included within the sale may be transferred prior to the acquisition to other members of the vendor's wholly-owned consolidated group, without giving rise to an immediate tax liability. However, a tax liability may crystallise if the transferred asset subsequently leaves the vendor's group. This is therefore a factor to consider on any future reorganisation of the vendor's group. Also, stamp duty may apply to the transfer of assets within a consolidated group, even if there is no income tax implication.

7.2.2 Distribution of Profits

Generally, dividends paid to offshore investors are subject to withholding tax unless they are franked (i.e. paid from after tax profits). As withholding tax is a final tax, no further Australian tax is payable on repatriated franked or unfranked dividends received by a non-resident.

Refer to Section 6.1 above for further details.

7.3 Asset Disposal

7.3.1 Profits on Sale of Assets

As for shares, a seller's main concern will be CGT upon the disposal of its assets. In addition, the sale of depreciable assets could result in a clawback of depreciation to the extent that depreciable property is sold above its tax written down value. In addition, any profit then needs to be distributed (refer section 7.3.2 below).

Unwinding, liquidating or maintaining the structure post-sale has commercial complications which a vendor may wish to avoid.

7.3.2 Distribution of Profits

Refer to Section 6.1 above for further details.

Dividends paid to offshore investors are subject to withholding tax unless they are franked (i.e. paid from after tax profits). As withholding tax is a final tax, no further Australian tax is payable on repatriated franked or unfranked dividends received by a non-resident.

Where a non-resident company operates an Australian branch, there is no tax payable on the remittance of branch profits to the foreign head office. However, Australia has a peculiar law which seeks to levy tax on dividends paid by non-residents which are sourced from Australian profits. This means that if a foreign company on-pays Australian branch profits to its foreign shareholders as a dividend, the shareholder is technically liable to Australian tax (which may be limited under an applicable DTA). However, in practice the ATO has jurisdictional difficulties in collecting this liability.

8. Transaction Costs for Sellers

8.1 GST

GST is paid at a rate of 10% in Australia by purchasers of most goods and services. However, it is the seller's responsibility to correctly account for GST on the supplies made.

The sale of shares between Australian entities is an input taxed financial supply. GST costs incurred by the seller in relation to the sale of the shares may not be recoverable in full.

Where a supply of assets satisfies the requirements for a sale of a "going concern", the supply will be GST-free. However, where the going concern requirements are not satisfied, the GST liability of the supply will depend on the nature of the individual assets.

The seller will be entitled to a full GST input tax credit on the GST costs incurred where the sale is a "going concern" or where the individual assets are all either subject to GST at a rate of 10% or are GST-free.

8.2 Stamp Duty

Stamp duty is generally payable by the purchaser, unless otherwise stated in the purchase agreement.

8.3 Concessions Relating to M&A

Certain concessions in relation to Australian income tax, GST and stamp duty may be available for the reorganisation of a company prior to sale.

8.3.1 Income Tax

The transfer of assets within a tax consolidated group is ignored for Australian income tax purposes. However, stamp duty may still apply.

8.3.2 GST

As mentioned above, there is a GST concession for the acquisition of a going concern. It is also a possibility for eligible companies to form a GST group. This effectively allows transfers of assets within the group to be disregarded. However, as discussed above, stamp duty may still apply.

8.3.3 Stamp Duty

Exemptions from stamp duty are available for certain qualifying reorganisations in some States. These exemptions typically feature a “clawback” provision, which seeks to enforce the stamp duty liability where certain transactions subsequently occur (such as a subsequent sale of particular assets or entities).

8.4 Tax Deductibility of Transaction Costs

Transaction costs incurred by a seller are typically included in the seller’s basis for the purpose of calculating the gain or loss on the transaction (per section 2.4.4).

9. Preparation of a Target Company for Sale

9.1 Transfer of Certain Assets to Another Group Company

In relation to the transfer of assets within a group, different rules apply for consolidated groups and non-consolidated groups. Consolidated groups are able to ignore the transfer of assets between members of the group under the “single entity rule” (although stamp duty may still apply).

Transfers within non-consolidated groups may trigger a CGT gain or loss – when transferring assets between entities and the consideration is not what would be regarded as arm’s length, a deemed market value is used to determine the gain or loss and provide the new cost base to the recipient company.

9.2 Declaration of Dividend Prior to Sale

Before the sale of a company, dividends may be paid in order to extract surplus cash. Where these dividends are paid to non-residents, withholding tax will be required to be paid if the dividends are unfranked (i.e. paid out of untaxed profits). Where the surplus cash represents repatriated dividends, no further Australian income tax will be payable.

10. Demergers

Australian tax law offers demerger rollover relief from CGT to tax consolidated groups and their shareholders. The key conditions are:

- at least 80% of the demerger group's ownership interest in the demerged entity must be acquired by the group's shareholders;
- each shareholder must receive an equal corresponding proportion of interests in the demerged entity (and no other consideration) equal to their interest in the group prior to the de-merger;
- the total market value of each shareholder's interests in the demerger entity and the group entity must at least equal the total market value of their interests in the group prior to the de-merger; and
- immediately prior to the demerger, either 50% of the group must be held by Australian residents or by non-residents whose interests in the demerged entity have the "necessary connection with Australia" (i.e. are an asset which is subject to the CGT regime) after the demerger.

Demerger dividends arising as a result of a demerger may not be subject to Australian tax.

Shareholders of the group apportion their basis across their existing shares plus the additional shares in the demerged entity.

11. Trade Sale or Listing

After acquiring a target, a financial buyer generally looks for an exit route either through a trade sale or an initial public listing (IPO). The Australian tax treatment will depend upon the residence of the acquirer and whether the acquirer holds the target on revenue or capital account.

Where an Australian resident holds the target on capital account, gains on disposal will be assessed as capital gains. A 50% CGT discount may be available to individuals or trusts if they have held the target for a period greater than twelve months. Where a resident is considered to hold the target on revenue account, proceeds from an IPO or other disposal will be assessed as ordinary income.

Currently, where a non-resident holds an interest in an Australian private company on capital account, the non resident is subject to Australian CGT on any gain made on IPO or other disposal if the disposal was of non-portfolio indirect or direct interests in TARP or the business assets of Australian permanent establishments (as outlined in section 7.2.1.1).

Where a non-resident shareholder holds shares in a Target Company on revenue account, the shareholder is currently subject to tax on any gain made as such gain is considered Australian sourced income, although the relevant DTA may override the domestic law. The status of the company and the level of shareholding are not relevant when the shares are held on revenue account. Whilst CGT may also apply to the disposal, there is generally a mechanism which seeks to avoid double tax.

In relation to GST, the supply of securities is treated as a "financial supply", meaning GST is not charged but a credit for GST paid on related expenses may not be available. However, where the supply is made to a non-resident, it may be "GST-free", which would allow a credit to be claimed for GST paid on related expenses.

If a company is seeking to be listed on the Australian Stock Exchange, the listed vehicle, which can also be the acquisition vehicle, should be incorporated in Australia.

12. Tax Incentives

Depending on the nature and size of the investment project, State Governments have given rebates from payroll tax, stamp duty and land tax on an ad hoc basis and for limited periods.

The major tax incentives / grants provided in Australia include:

- an outright deduction for certain relocation costs incurred in establishing a regional headquarters;
- accelerated deductions for capital expenditure on the exploration for and extraction of petroleum and other minerals and certain quarrying operations;
- certain tax-exempt non-resident investors that satisfy Australian registration requirements are exempt from income tax on the disposal of investments in certain Australian venture capital equity held for more than twelve months;
- taxable income derived from pure offshore banking transactions by an authorised offshore banking unit in Australia is taxed at a rate of 10%;
- Export Market Development Grant program which provides funding of up to $150,000 for expenditure in the development of eligible export markets; and
- a 125% deduction (increased to 175% for certain qualifying companies) for eligible research and development expenditure. A cash rebate may be available for small companies.
- a refundable tax offset of 20%-40% of Australian expenditure in making Australian films (the producer offset); a refundable tax offset of 15% of Australian production expenditure (the location offset); and a refundable tax offset of 15% for post, digital and visual effects production in Australia (the PDV offset). A tax payer can only claim one of these offsets.