Employee entitlements – need for clarity and tax planning opportunity

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Abstract: Complex negotiating issues arise where a vendor, owing employee entitlements at the time of sale, sells a business. These complexities arise because of two tax aspects of the entitlements in the sale transaction. First, the Commissioner considers any employee entitlement assumed by the purchaser as part of the consideration for the CGT event relating to the sale of the business. Secondly, when a purchaser who has assumed them pays the employee entitlements the purchaser is likely to claim a tax deduction for the amounts paid.

This article discusses a tax planning opportunity which may become available if the business sale is structured appropriately. The Commissioner's approach, of including the amount of the employee entitlements assumed by the purchaser in the capital proceeds of the sale, leads to the conclusion that both parties will be better off if the employee entitlements are paid out by the vendor before the sale occurs.

Introduction

The proper tax treatment of employee entitlements when a business is sold is a source of difficulty. The approach taken by the ATO when assessing the employee entitlement component of the sale of a business, itself a questionable approach, makes it in both parties' interests to pay out the entitlements before the sale occurs.

Surprisingly, the appropriate treatment of employee entitlements upon the sale of a business continues to cause difficulty for solicitors and accountants. This is surprising because of the frequency with which business sales occur. The difficulty arises because of the tax treatment of those amounts.

The Commissioner of Taxation's ('Commissioner') approach assesses the employee entitlements as consideration for the sale. It is questionable and should, at the very least, be stated and supported with reasoning in a public statement by the Commissioner. Despite this, the Commissioner's approach provides a tax planning opportunity, available if the business sale is structured appropriately.

References to 'employee entitlements' throughout this article denote entitlements such as long service leave, annual leave and sick leave liabilities that are owed to employees by the owner of a business. Although focusing on employee entitlements, the point made in this article will apply to any amounts that, when assumed by a purchaser, form part of the capital proceeds of the sale and will be tax deductible to the purchaser when paid at a later time.

Other considerations will be relevant to most, if not all, business sales. The entity selling the business, the availability and use of the small business concessions and any losses available to the vendor are but a few. However, regardless of the other considerations this point remains: later deductible amounts assumed by a purchaser offer an arbitrage advantage to the both parties of the sale.

The problems

Complex negotiating issues arise where a vendor, owing employee entitlements at the time of sale, sells a business. These complexities arise because of two tax aspects of the entitlements in the sale transaction. First, the Commissioner considers any employee entitlement assumed by the purchaser as part of the consideration for the CGT event relating to the sale of the business. Secondly, when a purchaser who has assumed them pays the employee entitlements, the purchaser is likely to claim a tax deduction for the amounts paid.

This results in the vendor being assessed (on capital account) on the amount of the employee entitlements and the purchaser claiming a tax deduction for those amounts when subsequently paid. Aware of this fact, vendors often seek to access some of the purely commercial advantage. Primarily the vendor will seek to increase the purchase price by the amount of tax the purchaser will not have to pay because of the deduction referrable to the employee entitlements assumed.

This article argues that the Commissioner's approach(of including the amount of the employee entitlements assumed by the purchaser in the capital proceeds of the sale) leads to the conclusion that both parties will be better off, at the expense of the Commissioner, if the employee entitlements are paid out by the vendor before the sale occurs.

Commissioner's approach to employee entitlements

On the sale of a business the vendor will be assessed on the 'capital proceeds' received in relation to the sale of the business. For instance, section 103-10 of the *Income Tax Assessment Act 1997* (Cth) ('ITAA 1997') states that

> "This Part and Part 3-3 apply to you as if you had received money or other property as if it has been applied for your benefit (including by discharging all or part of a debt your owe) or as you direct."

However, there is an argument that the rules that modify the capital proceeds for capital gains tax purposes, for instance section 116-55 of the ITAA 1997, do not include the employee entitlements assumed by the purchaser because they are 'a liability by way of security over the asset'. That is, the employee entitlements, being a liability of the vendor that is unsecured, will not be considered to be part of the assessable amount received by the vendor on the sale.

The Commissioner does not see the world this way. In the National Tax Liaison Group (NTLG) Losses and CGT Subcommittee meeting on 10 November 2004 the Commissioner, via the Australian Taxation Office ('ATO') employees representing him there, stated that the employee entitlements would form part of the capital proceeds. Minutes of that NTLG meeting, available
on the ATO website, relevantly state:

> **"What is the capital proceeds where liabilities are assumed on sale of a business?**
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> What is the capital proceeds from a CGT event where the purchaser of a business assumes long service leave, annual leave and sick leave liabilities on the purchaser of a business and the purchase price is reduced accordingly. …
>
> The amount the purchaser agrees to pay to creditors of the business is money that has or will be applied for the benefit of the vendor. For liabilities that are, and remain, the personal liabilities of the vendor, it is part of the purchase price that is paid at the direction of the vendor to a third party.
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> For business liabilities that will transfer from the vendor to the purchaser, it is part of the purchase price that has been applied for the benefit of [the] vendor because the purchaser has taken over those liabilities. Even though the liabilities may be transferred to the purchaser, it is only by virtue of the purchaser acquiring the business that the vendor becomes freed from the liability.
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> Accordingly, the capital proceeds from the CGT event is the gross amount."

That the Commissioner's view on this issue, which appears not to be in accordance with the legislative provisions, is expressed informally in an NTLG meeting is regrettable. The frequency of business sale agreements, almost all of which involved employee entitlements, warrant the Commissioner's attention – a public statement (such as a Taxation Determination of an Interpretative Decision) that sets out the reasoning of the Commissioner's position in relation to employee entitlements and capital proceeds would assist in the circumstances.

Although such a public statement would not be law,[1] in dealing with tax matters on a daily basis, such pronouncements by the Commissioner provide much assistance. Caution should be exercised, however, to ensure they are not given more authority or weight than they actually have. When called upon to determine this issue (where the author's searches have not found a case on this point) a court may hold the Commissioner to be incorrect.

In light of the above, and given that seeking to disprove the Commissioner in court is rarely a commercial outcome for clients, what are advisers to do? Fortunately there is an approach available to parties to a business sale transaction that will maximise their after tax positions consistently with the Commissioner's view.

Tax-effective approach

Broadly, there are three approaches that can be adopted when structuring a business sale involving employee entitlements:

(1) the purchase price for the business is reduced by the amount of the employee entitlements assumed by the purchaser (the 'gross-reduction scenario');

(2) the purchase price for the business is reduced by the amount of the employee entitlements assumed by the purchaser, after taking into account the tax benefit the later deductions will provide to the purchaser (the 'net-reduction scenario'); and

(3) the vendor pays out the employee entitlements before the business is sold for the purchase price unaffected by the entitlements (the 'prepaying scenario').

In practice the net-reduction scenario usually involves the parties compromising so that both parties access the tax benefit from the deductions, the extent depending on the parties' negotiating strengths. To highlight the point, however, this article will assume the net-reduction scenario involves entire tax benefit of the deductions being provided to the vendor.

> “Complex negotiating issues arise where a vendor … sells a business”

Transfer of deductibility

Under section 26-10 of the ITAA 1997 a taxpayer can only claim a deduction for losses or outgoings of accrued long service leave, annual leave or sick leave where:

- the amount has actually been paid to the employee to whom the leave relates;
- the loss or outgoing is an 'accrued leave transfer payment' (which is defined as accrued leave entitlements payments made by an employee where the payment is made under an award or industrial agreement).

Where the purchaser assumes the employee entitlements the vendor will not have paid them to the relevant employees. They will therefore not be deductible to the vendor when the purchaser assumes them. Importantly for the vendor, the fact that the relevant employee's rights to the employee entitlements accrued while the vendor owned the business would not remove the purchaser's ability to claim a deduction for the amounts paid to the employees.

Illustration

The combination of the Commissioner's approach of including employee entitlements assumed as capital proceeds and the transfer of the deductibility to those entitlements from the vendor to the purchaser results in the best overall position of the parties being the prepaying scenario. A simplistic, albeit quite a specific example, will assist in illustrating the point.

Assume that Vendor Pty Ltd ('Vendor') intends to sell its business to Purchaser Pty Ltd ('Purchaser'). Having built up the business from scratch, Vendor Pty Ltd has a negligible cost base in relation to the sale of the business. The parties agree on a purchase price of $1 million, being the market value of the business. Vendor Pty Ltd, in running the business, owes $200,000 of employee entitlements at the time of the sale. As both parties are companies their tax rates are 30% whether the income is on revenue account or made assessable as a capital gain.

The table set out at the end of this article shows that the parties are better off, and the Commissioner correspondingly worse off, by the parties adopting the prepaying scenario. The table, and this example generally, incorporates the tax position of the Purchaser after it acquires the

business. This is necessary as much of the tax characteristics the Purchaser will have in relation to the business are set at the time of acquisition – to properly reflect the overall effectiveness of the scenarios the Purchaser's future tax exposures are therefore included.

Under the prepaying scenario only $240,000 tax is payable to the Commissioner. The Vendor pays the $240,000 in tax, retains $560,000 in cash (considering the employee entitlements it had to pay) and the Purchaser has a cost base equal to the business's current market value.

Under the net-reduction scenario $300,0000 tax is payable to the Commissioner. The Vendor pays $318,000 in tax and retains $560,000 in cash. The Purchaser has a capital gain exposure of $140,000 (being the market value of the business over the cost base the Purchaser has in the business) but has deductions of $200,000 for the employee entitlements it will make. The Purchaser, in retaining $60,000 worth of deductions after wiping out the capital gain, will reduce future tax liabilities by $18,000.

Under the gross-reduction scenario $300,000 tax is payable to the Commissioner. The Vendor pays $300,000 in tax and retains $500,000 in cash. The Purchaser has a capital gain exposure of $200,000 (being the market value of the business over the cost base the Purchaser has in the business) but has deductions of $200,000 for the employee entitlements it will make. The Purchaser therefore pays no further tax if the business was sold at the current market value.

Table 1: Identifying tax-effective approach

	Item	Gross-reduction scenario	Net-reduction scenario	Prepaying scenario
General Items	Purchase Price	$1,000,000	$1,000,000	$1,000,000
	Cash paid to the Vendor	$800,000	$860,000	$1,000,000
	Employee entitlements assumed by Purchaser	$200,000	$200,000	–
The Vendor	Capital Proceeds (on the Commissioner's view)	$1,000,000	$1,060,000	$1,000,000
	Tax paid on the sale of the business	$300,000	$318,000	$300,000
	Employee entitlements paid by Vendor	–	–	$200,000
	Deductions available to Vendor from paying entitlements	–	–	$200,000 (saving $60,000 in tax)
	Total tax paid by Vendor	$300,000	$318,000	$240,000
	Cash retained by Vendor	$500,000	$542,000	$560,000
The Purchaser	Cost base in the business	$800,000	$860,000	$1,000,000
	Capital gain that would be made at current market value	$200,000	$140,000	–
	Deduction available to Purchaser from paying entitlements[2]	$200,000	$200,000	–
	Purchaser's tax exposure from the sale transaction	–	$60,000 deduction (or $18,000 tax saved later)	–
Conclusion	Total Tax Paid to Commissioner	$300,000	$300,000	$240,000

Conclusion

There is therefore a difference between the prepaying scenario on the one hand, and the gross-reduction and net-reduction scenarios on the other hand. This difference results from the Commissioner assessing the Vendor to capital gains tax as if the employee entitlements were received by the Vendor without a corresponding recognition of those amounts in the cost base of the Purchaser.

When the employee entitlements are assumed by a Purchaser they are effectively subject to capital gains tax twice – they are assessed to the Vendor and the Purchaser does not include the amount in their cost base. The deductibility, on revenue account, of the employee entitlements is available whether or not it is the Vendor or the Purchaser that pays them. This results in the most tax-effective outcome being for the Vendor to pay out the employee entitlements before the business is sold.

There are commercial considerations at play, such as whether the Vendor can fund the payment of the employee entitlements. But should these commercial considerations be surmountable, there is an amount (the tax rate of the parties applied to the amount of the employee entitlements) of saved tax that can be shared by the parties rather than given to the Commissioner.

Advisers should make their clients aware of this potential "win/win" for the Vendor and Purchaser.

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References

1 Although the rulings may be binding on the Commissioner (section 357-60 in Schedule 1 to the *Taxation Administration Act* 1953 (Cth) and *Practice Statement PS LA 2008/3*) they are not binding on taxpayers who take a contrary view to the rulings.

2 There is clearly a timing issue here in that the entitlements will not be paid immediately. The point made, however, is that future deductions will be available to the Purchaser.