

The tax implications engaged in selling a business

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Use of a case study has been made to highlight some of the pitfalls when selling a business, focusing specifically on the different tax consequences between selling shares in a company and selling the business of a company. For this purpose assume the following facts:



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you own shares in the company, which were valued at R10m on October 1 2001 (the commencement date of CGT)

the purchaser is willing to pay a purchase price of R20m
the net asset value of the business is R5m at 1 October 2001
the net asset value at date of sale is unchanged at R5m
the goodwill at October 1 2001 is valued at R5m (R10m – R5m)
the goodwill at the date of sale is R15m (R20m – R5m)

The sale of a share amounts to the disposal of an asset and is consequently subject to CGT. Essentially, a capital gain or loss is determined by deducting the base cost of an asset from the proceeds realised on its disposal. Most CGT planning revolves around minimising capital gains by maximising the base cost. The base cost of an asset would normally be enhanced by certain expenditure, specifically provided for in legislation, incurred in relation to the asset.

CGT became effective from October 1 2001 and special rules apply, therefore, to the determination of the base cost of an asset acquired before this date. This ensures that only post October 1 2001 growth is subject to CGT. The effect of these rules is that the value of the asset had to be determined when CGT became applicable, the so-called 'valuation date value.' This value is included in the asset's base cost together with any allowable expenditure incurred thereafter. The base cost can, therefore, be maximised by ensuring application of the highest possible valuation date value and the inclusion of all allowable expenditure after valuation date in the base cost.

The legislation allows for different

methods of calculating the valuation date value:

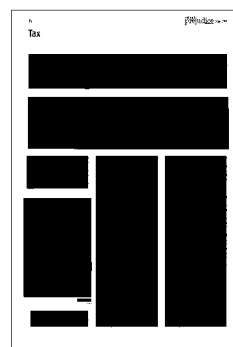
- the time apportionment base cost (TABC) method, (which effectively apportions the gain between the period before and after October 1 2001 on a time basis)
- 20% of proceeds; and
- the market value at valuation date

The determination of the valuation date value is not as simple as it appears – there are some complex rules that apply to limit capital losses by determining what valuation date value is used.

The first step in maximising the base cost is (where the option is available) to determine which method will provide the highest valuation date value. If the market value is the best method, keep in mind that this method can only be applied where that value was determined before September 30 2004. In addition, if the total value of your shares exceeded R10m, a valuation certificate (as prescribed by Revenue) had to be submitted with your first tax return after September 30 2004.

The base cost of shares will consist of the valuation date value as well as certain expenditure incurred in respect of the shares after October 1 2001. The following types of expenditure can be included in the base cost (thereby limiting the tax payable):

- expenditure actually incurred in respect of the valuation of the asset for the purpose of determining the capital gain or capital loss in respect of the asset
- expenditure actually incurred directly relating to the disposal of the asset



including:

- remuneration paid to an accountant or legal adviser for services rendered
- stamp duty arising from the transfer of the shares

- any expenditure that may have been incurred in maintaining or defending legal rights to the shares

An important aspect of planning is the maintenance of proper records providing evidence of the amount to include in the base cost. Valuations performed as at October 1 2001, as well as invoices etc which serve as proof of other costs incurred, which may be taken into account in the determination of the base cost should be safeguarded.

The effective rate at which the CGT will be taxed as an individual is 10%. Assuming the market value gives the highest valuation date value, your gain would be R20m - R10m = R10m and (assuming other expenditure incurred in respect of the shares is ignored) your CGT liability will be R1m.

If the shares are sold, the tax liability is calculated as follows:

Proceeds	20 000 000
Base cost	(10 000 000)
Capital gain	10 000 000
Less individual's annual exclusion	(10 000)
	9 990 000
Portion included in taxable income (25%)	2 497 500
Taxed at 40%	<u>999 000</u>

Selling a business, as opposed to the sale of the shares, has tax implications at both the company and shareholder levels. At company level, there are two main types of tax arising on the sale of the shares: CGT and STC.

The sale of a business implies the sale of a group of assets and liabilities comprising the business. To the extent that a business is worth more than its net assets, an intangible asset in the form of goodwill arises. (For the purpose of this illustration assume the assets other than goodwill are sold at cost and therefore no gain or loss is realised on these assets).

The disposal of goodwill amounts to the disposal of an asset and is also subject to CGT. Once again, from a tax planning perspective, maximising the base cost of goodwill reduces capital gain.

There are some pitfalls surrounding the determination of the valuation date value of goodwill. It is Revenue's view that the Time Apportionment Base Cost (TABC) method is not available for determining the base cost of goodwill (though, in our

opinion, this is debatable). Because goodwill is an intangible asset, a valuation certificate needs to be submitted if the value, at valuation date, exceeds R1m (not R10m as is the case of tangible assets). A business is not considered to be a separate asset for CGT purposes and, therefore, the valuation of the business as a whole may be inadequate. Because the taxpayer in this case is the company, the capital gain will be taxed at an effective rate of 14.5% (as opposed to 10% in the case of a natural person).

Generally, STC is imposed at a rate of 12.5% on the net dividend declared by a company. Assuming that the company has no revenue reserves at the date of sale and the full proceeds

arising from the sale of the business are distributed to shareholders, the full amount will be subject to STC at 12.5%.

In the past it was possible for a company

to distribute capital profits STC free if the distribution was made in the course of, or in anticipation of, the liquidation or deregistration of the company. With the introduction of CGT, only that portion of the capital profits representing capital growth that occurred prior to valuation date will be exempt from STC under these circumstances.

The portion subject to STC will be the difference between the proceeds arising from the disposal of capital assets and their market value at October 1 2001. Unlike the CGT provisions, there is no requirement that this valuation must be done prior to September 30 2004 or that any valuation had to have been submitted. From a tax-planning perspective it may be worthwhile to value the assets now, as the further you get from the valuation date the more difficult it is to source accurate data on which to base a valuation.

In addition, to ensure that at least the pre October 1 2001 capital growth is not subject to STC, steps, as prescribed by the Income Tax Act, need to be taken to have

the company liquidated or deregistered within six months.

Assuming that the business is sold, the calculation of the tax liability will be:

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Proceeds on sale of goodwill *	15 000 000
Base cost on sale of goodwill	(5 000 000)
Capital gain	10 000 000
Portion included in taxable income (50%)	5 000 000
Taxed at 29%	<u>1 450 000</u>

* remember the other assets are sold at their base so no CGT arises if the company subsequently deregisters or liquidates

STC:	
Total capital profit subject to STC	10 000 000
Less CGT paid	(1 450 000)
Capital profits available for distribution	8 550 000
STC @12.5%	<u>950 000</u>
Total tax (CGT&STC)	2 400 000

Though not specifically mentioned, there are some exclusions from CGT where business assets are disposed of by natural persons. An exclusion of R750 000 applies (over the period of the taxpayer's life) where the following conditions are present:

- The taxpayer must have held the assets for his/her own benefit for a continuous period of at least five years prior to disposal;
- The taxpayer must have been substantially involved in the business during this period.
- The taxpayer must have attained the age of 55 years or the disposal must be in consequence of ill-health, other infirmity, superannuation or death;
- The taxpayer must have realised the capital gains qualifying for the exclusion within a period of 24 months, commencing on the date of the first disposal; and
- The taxpayer must not have owned more than one business where the total market value of all the assets of those businesses exceed R5m

Some important actions can be taken to limit the CGT and STC costs of selling a business. It is generally better to sell shares rather than the business (the difference in the example is R1 401 000). These costs should be considered when negotiating with a potential purchaser.☺

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