The Deal Room Podcast

Episode 207 – Trap alert: Watch out for these mistakes in Terms Sheets and Heads of Agreement

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Transcript

Joanna:
Hi, it's Joanna Oakey here and welcome back to The Deal Room podcast, a podcast proudly brought to you by our commercial liquor practice, aspect legal. Now today we are talking to Paula Tallon, the Tax Director at Prosperity Advisors group, all about the traps that can occur in having commercial term sheets that are too detailed. We cover a lot of things today that you just may not have thought about when you're preparing your heads of agreement or your commercial term sheet documents. So this episode is perfect for you. If you are a buyer or seller of a business and are looking at entering into a heads of agreement or commercial term sheet as a prelude to your business sale agreement, or indeed if you're an advisor, if you're a broker or corporate advisor, or an accountant, working together with your clients who are entering into deals, buying or selling shares, or businesses and of course, as I said, I have the fabulous Paula Tallon, the Director of Taxation at Prosperity Advisors Group here today to talk about her experiences from a tax perspective. She's got more than 25 years experience across large and mid tier accounting firms throughout Australia and the UK, so Paula really brings a very practical approach to thinking about tax efficient structuring at succession and exit as we look at this topic today. So without further ado, here we go with our discussion with Paula.

Joanna:
Wonderful, Paul, uh, so exciting to have you on The Deal room Podcast, again, a serial guest,

we love having you on the podcast Paula.

Paula:
Thank you, Joanna, delighted to be here today.

Joanna:
Great. Okay, wonderful. Now, look, I just think this is such an important topic that we're talking about today. I love talking about the tips and traps, in business sales and acquisitions. And your case study from today is an absolute beauty. I just am so excited to dig into it. So maybe it let's I guess stepping back. We talked about heads of agreements today. So heads of agreements, or and I find what's interesting, Paula is there is actually so many different names that are given to this document. So you can call it a memorandum of understanding or commercial term sheet, you know, non binding indicative offer which might accidentally be actually binding the ultimately, whatever you call these documents, there are a document that contains the commercial terms between the parties, and a generally have a component of binding and non binding elements for the parties in relation to setting out the deal terms. And then that is a prelude to the parties then entering into entering into that formal agreement of the business sale agreement, the share Sale Agreement later on down the track. So tell me Paula after we've given a bit of an intro into what a heads of agreement is, tell me the issue that occurred this day that you found so fascinating with this particular heads of agreement in a business sale.

Paula:
Joanna you know a heads of agreement, as you say that can be called anything. And I always liken them to something between that sort of verbal and the handshake thing you do to sell your business to the very detailed binding contract for sale. But what I've seen quite a lot of is individuals who are selling their businesses, getting agreement heads of agreements off the internet or getting done by people who are not lawyers. So what happens is the details that start to go into these heads of agreement, actually be end up being what you would have in a sale and purchase agreement. So instead of just having those binding terms of regarding confidentiality, exclusivity and indicative term, Terms of the deal, you end up they start to trash out all the details you would in a sale and purchase agreement. So the end up with enormous a binding contract or said that you're the lawyer so he'll know all about that. But from my tax perspective, why do I even care? Well, I care a lot because when you're making a disposal or selling your business for capital gains tax purposes, the taxing point is all about when you enter into that binding contract for sale. So you may think you're entering into heads of agreement and thinking, well, that's great. I'm doing that on the 28th of June. And then in July following tax year, I'm going to trigger my sale. But in fact, your heads of agreement is so detailed, that that actually is a binding contract of sale for tax purposes. So you can end up triggering your disposal earlier. Now, if you're someone who's just brought your tax for the year, that's not so bad. But what if you're somebody who's relying on a small business CGT concession, and you know, your 15 years is going to be up on the fifth of July, so you decide you're not going to sell after the fifth. But somebody has helpfully put together a really detailed heads of agreement and triggered your tax point early. So instead of yourself being exempt from tax, you end up with a tax charge on it. So that's why I care about it. And that's why I'm just so passionate and looking at these documents.

Joanna:
Do you know what? I mean, it's just such a fascinating, it's such a fascinating example of an issue that can pop up that can be created by overzealous planning, perhaps, or an overzealous approach to wanting to make sure the deal is just so clear between the parties that you've actually created this issue into the future. And I guess, the tax, there's the tax issue, and I want to come back to that in a moment, because I think that's such a critical point that many people may just not even think about. But also this binding versus non binding nature, I think is critically important as well, because some of the reasons that might drive the this term sheet to be really detailed. And to try to get the parties bound is because you know that there's this competing tension between both of the parties in relation to not wanting to waste time muck around with someone that not is not going to complete the transaction, not wanting to get exposed to excessive legal costs. And this works both sides, you know, and not wanting to lose the

opportunity of the transaction, once you've started to get knee deep into it. And as I said, this can both be a buy side pressure and a sell side pressure. And this is what I see sometimes drives this, these move towards wanting to get super detailed in the term sheet. And whilst it can be very sensible to have detail in the term sheet in terms of clarifying that understanding of both parties, in order to help you to move to the next stage to to then ensure that you've locked down the number of areas of negotiation, you know, because you've, you know, the concept being clear on the high level commercial terms, the risk is that the further we get into the transaction, then there might be this requirement in any event, to relook at some the way that some of those commercial terms work. And when you there's this whole body of law around whether or not an agreement to agree, is enforceable. And you know, I've seen this play out a few times, and it's a really unpleasant space, when you've got one person who believes they have an unenforceable contract and another party that doesn't, you know, and they're then at war working out, you know, what bits of it are, indeed, enforceable. But you know, so So from my perspective, from the legal perspective, I think that's the issue, if we're getting more detailed than just a couple of pages in our commercial terms, documents, where we setting out the, you know, the price and the payment terms and the and, you know, the exclusivity period, and confident due diligence, and a bit of a timetable maybe and confidentiality, yes, sorry, go who

Paula:
was concerned that the key terms you didn't expect to see in there. And when the parties get knee deep into negotiating on their heads of agreement, what you find is because that takes so long, they almost do get into the full sales process, except so they forget to see the heads of agreement for what it actually is. It is really just that term sheet, setting out the key terms around the offer, you know, whether it's an acquisition of shares, whether it's an acquisition of the assets, the price, as you say, any major adjustments on that price is always going to be smaller ones which come out in the sale and purchase agreement. But any big adjustments may be in relation to employee leave entitlements, or if there are any assets which have to be transferred from something else. So maybe if there's big contracts, what's going to happen in the interim period, but it's just, you know, seeing taxpayers who spent so long building up this business and not Being able to avail of a concession that they should rightly be entitled to, then I just find that very hard to, you know, I always say to people selling a business, please just speak to someone early. Because if you get your team on site from day one, your team can actually guide you in the right direction. They can take you through this process. Because if not, you can find yourself in a very lonely process where the person who's buying your business that much bigger than you, they've got a really slick team, and they're just firing these documents at you, and you don't want to be a burden. So you're just working through with them without actually taking your own advice.

Joanna:
Yeah, absolutely. Absolutely. And let's sort of stick in stepping back and driving into where that potential tax issue can come from. Can you talk to us a little bit about what is it that are things that could be at risk, if they end up in a, in a heads of agreement document, that model commercial term sheet, whatever we're talking, calling it? What are the risk areas that could lead to it from a tax perspective, being seen as being, you know, a contract formed at that earlier date, rather than a later date that the parties may have actually intended. And maybe also, within that, if you can explain to us the difference, the high level difference in a taxing position between, you know, that whole entering into a contract versus the business passing over as well?

Paula:
Yeah, so since you ran it, the key risk is down to timing. So if the contracts entered into earlier than you otherwise think, then you trigger the tax point earlier. Now, if you enter into the heads of agreement in May, and then you do your sales contract in June, that may not be an issue for you, because it's all in the same tax year. But if you're trying to make sure that your disposal of the business happens in a later tax year, and you have such a detailed heads of agreement, that you trigger your tax break before the end of the financial year, then you'll bring forward or the payment of the tax on that transaction. So that's a big risk because the cost of money, but the bigger risk is where you're working to towards those concessions. And you know that you

have to say hit the 15 year period, and you worked out to a very fine line when that 15 years is because you're really close to it. And then you inadvertently trigger the tax point earlier, then you're in a position where you've triggered it early, and you don't get your CGT concession, which means the gain you thought was disregarded and you are paying zero on then you're in a position that you have got a tax charge on that. And the other things that can trip you up, if you do end up making it into a binding contract is in relation to just how that sales price is split. So the person buying the business, they make an offer to acquire the whole business. And there's typically a price on that. Now, if I'm acting for the person disposing of the business, I want to make sure that in as far as possible, the amount they're getting is in relation to the goodwill that's in our business or in relation to a capital asset, if it's not the sale of shares, because that way, I know well, I'm going to get my 50% CGT discount, I'm probably going to get my small business CGT concessions, and that's going to be really tax efficient for me. But if the heads of agreement have already divided up the sales proceeds, I live allocated say a million dollars to equipment, well equipments, not a capital asset. equipment works and under the depreciation rules, and most of the people selling businesses have already depreciated their assets down to zero for tax purposes. So that whole 1 million is a taxable profit, it's assessable profit in the year it's triggered, you don't get any CGT concessions. So you know, going into that level of detail and heads of agreement can have drastic tax consequences. I was looking at one a few weeks ago where the transaction had already happened. And I was being asked for my opinion as to how this should be disclosed. And when I looked at this, they had the original thing was the transaction has happened in the 21-22. financial year, when I looked at it, the transaction that actually happened in the previous financial year, and hadn't been on the lodged return because they had this detailed heads of agreement. Now there are lots of things you can do you know, to you will go down the route of trying to, I suppose disprove that it's a binding contract, but I'm seeing such big heads of agreements, some of them are picking sale agreements, and it's scary, because the terms and everything they're going into such detail on everything that you think wow, this is like the real final stages of nearly negotiating last sale and purchase agreement. So they've gone down to that level of detail. So I suppose the messages is keep it at a high level, isn't it capture the key terms of the deal and as you say lock in the you know the binding terms are going to be the confidence Today confidentiality, exclusivity, they're the two things you really want to lock in.

Joanna:
Yeah, absolutely. And and, you know, I guess if we step back also and say, Well, what's some reason that we are ending up with these high level detail in the term sheet, and one of the things I alluded to, and I really want to hear your thoughts, pull it from an accounting perspective, why it might be that it might be seeing that this is a good idea to enter into this detail. But you know, I can see from a risk perspective, as I discussed earlier, both on the buy side and the sell side, there's always this. There's this sort of weighing between wanting to get the commitment of the deal, and protect against your own expense and exposure in the deal. And I just from a legal perspective, there's so many other ways that you can achieve that rather than a really long and detailed term sheet. And there's lots of ways to achieve it. But one of which is you can, you can actually enter into a sale contract. But which has conditions precedent, that mean, you have certain elements that need to be ticked off before the agreement is itself binding. And, you know, that can in many instances be a far superior approach to entering into a long and detailed term sheet, which precedes, you know, the sale agreement, just entering into the sale agreement itself, but giving outs that work in in various occasions. So from my perspective, from a legal perspective, that's sort of the reason quite often I see it, and the alternative sort of approach to deal with it. From your perspective, pull out what are some of the accounting reasons that you might see driving a desire to have such detail in in heads of agreement?

Paula:
Joanna, I think it all comes down to the emotion behind buying and selling businesses, because once people have emotionally committed to either buying or selling that business, they want to make sure that nothing goes wrong. Yeah, so they want certainty. And the way they think, to get that certainty is to outline it all into their heads of agreement. And this is where, you know, when you're selling or buying a business, you really need some your team in between, because your team, they do care about you deeply. But they haven't got that same emotional

involvement. Yeah, because it can be quite stressful selling a business, and something you've built up over the years. And then you want to make sure that there's no price chipping. And we've talked previously about this price chipping. So you know, someone offers you 5 million for your business. And by the time you get to the end of your contract, that price has gone down because they've chipped away at it because they said oh, well, you've got more employees and more leaves than we thought or your assets are older than we thought your contracts aren't as long as we thought there would be and there's all these kinds of price chipping that goes on. So I suppose one of the reasons why people go into detailed heads of agreement is to avoid the price chipping exercise. Yeah. And that's the difficulty because you can go into it binding heads of agreement, if that's what you want. And that's when you want to trigger your tax point. But I think it's more have caution and be aware of what's happening. And just don't assume because it's a head of heads of agreement, it's not going to trigger the tax point. Because if you want to trigger tax point, then you could.

Joanna:
Yeah, and that's interesting. When you say if you want to trigger the tax point, then you could so maybe talk us through a little bit what what will be the reason for that? And what are some of the methods that you can go about to achieve that?

Paula:
Well, it's I suppose if somebody wanted to trigger those sale in a particular tax year, maybe they wanted to bring forward as sale maybe there's there's various planning reasons why you might want to do it for individuals or entities that are involved in the business. So in which case, then you would make sure that you enter into a binding contract, whether a binding contract, per se, or your heads of agreement is so strong that it is binding. So even though we don't normally see people rushing into trying to trigger the tax point for most people I speak to are trying to delay it for as far as possible. And even where they have got some of the CGT concessions and have a little bit of a liability. We still do the rollover so you can have an extra two years into up to pay your tax. Because let's face it, all of us want to pay our tax at the last possible moment. You know, it's the hardest thing that we do. So most people are trying to defer the tax point rather than bring it forward. But it's just when you see people falling into a trap that they were completely unaware of and then it suddenly becomes outside of their control. Or by the time we get to it as advisors, the damage is already done. And it's quite hard to unravel from that. Yeah. Because you've got to almost start again and walk away from the sale and walk back into the sale. And, you know, if as this person selling your business, you've already mentally spent loads of that money, then you're not going to walk away, you'll go well, okay, I don't get my concessions. I will live with that I'm still getting more than I otherwise thought I would get. And it's it's amazing, this sort of rationalization that starts to go on. You, they they talk themselves back to a position that this is still okay.

Joanna:
Yeah, yeah. And look at the basis of what you're talking about here that we haven't, I guess, pointed out and and I really want to point out is this importance of tax planning and the timing around all of this sale environment. And we've talked numerous times before Paula about the importance of tax planning, the importance of walking into a transaction, understanding, you know, what your options are, and what what is what the outcome will be from a tax perspective based on different options that you might choose. But timing is obviously another critical component of this planning. And I guess the answer is, once again, don't walk into a deal without having had those proper discussions from a tax perspective, from a legal perspective and understanding exactly what you're doing at every step of the way.

Paula:
Yeah, don't sign anything. I haven't signed it, then you were okay. Just, you know, the amount, the amount of times I've had, oh, I have a quick phone call. I'm sure it's all fine. And they took me through what's happening. And there's normally a slightly different way we could go our big things that may be missing from what they were looking to do. Yeah. And there were the one I see so much of is an individual selling going, well, I know, I qualify for the CGT concessions. So I've got no tax to pay on my sale. And they go, Well, what else are you selling? And you know,

going back to that equipment, you could be selling your equipment, you could be having value in equipment, and actually you will have a gain on your equipment and again, will be taxable. But because they've been told you've had your business 15 years, your whole gain is disregarded. Nobody's taken them through the process of, well, if you're selling the business itself, you've got a breakdown of all these other things, because you've got your stock, your stock could be sold at market value, there's your trading profit, your equipment goes across it value, there's assessable income, you've CGT concessions, your capital gains, tax concessions won't help you with those kinds of profits. So that's where the deal structuring comes in as well knowing then whether you're selling your shares, your assets, or whether you know, what's available, what does the purchaser want to buy?

Joanna:
Yeah, and one one other thing that I just wanted to add, before we leave, that I've written a little note for myself of as we've been talking is options as well, because I think, you know, this perhaps is getting a little bit too technical. But options are a way of achieving a future, right for something to occur, whether or not it's your right to force some sort of sale in the future or someone else's right to, to buy or your right to buy whatever. But of course, when we're thinking about options in a business sale and purchase environment, we really need to be thinking about taxing dates as well, I guess.

Paula:
So if you've got options, typically your taxing day for the sale of the business will be when the business passes under the option. But there may be option fees that are upfront that need to come in to the assessable income in that particular year. And remember, if you're granting an option to someone, well, that's not going to get you any concessions, because you're not disposing a part of a business. And it's also you're creating a new right, so you haven't held it for 12 months, you will get a 50% discount. So, you know, it's just considering how those opportunities are going to be taxed. And also, we see the use across options, you know, the color pot options, which, you know, in my mind, they achieve the same kind of thing as a binding contract for sale, but they're not a binding contract of sale. Because if I agreed to sell my business to you, and you agree to buy my business, well either of us could force it so it could be outside our control, but then neither of us both of us could do nothing. And then we do nothing it never actually happens. Yeah, so of course options can be quite good. If you know you definitely want to sell your business and you're happy to sell at a later date for the price that's agreed now,

Joanna:
and the other way that quite often we see that discussion occur in relation to options, whether it's The whole business sale, whether its shares, you know, in terms of a certain proportion of shares being sold initially with this, you know, an option for the the final parcels of shares for a later date, also property. So property can be one of those things, and I don't want to dwell too much on this. And perhaps we need to come back and talk all about tax on options at some point, Paula. But just just as a quick, you know, quick overview or sort of, you know, insight into what we might talk about there, I think you just have to be really important in considering if you're using options as a way to perhaps achieve the ability of the property sale, but post dated because of some future better tax environment that may relate to retirement age, for example. I think, you know, there's many sort of tax, you know, traps for the unwary here, pull up,

Paula:
there's tax traps left, right and center. You know, even in relation to land tax duty, there's all kinds of things that can come up on that. And there's some recent changes announced in relation to duty and how that would impact where options are in place. So you could end up triggering a duty point paying someone paid duty and never actually getting their hands on the property. Yeah, so there's those kinds of things and then GST and property. That's a whole other session. And that's just a constant thing, which comes up over and over again, on the sale of property. And I know we don't digress slightly, but the just assuming that the sale of a property is is supplied as a going concern, it's not always and the ramifications of that can be quite big as well. Well,

Joanna:
I feel like we have so many things to come back and talk about again Paula on another episode. Who would have thought tax could be so exciting. Pull a new poll a new. Look, Paula, thank you so much for coming along. It's so good today to talk about some of those issues that you know, quite often just not in the minds of our buyers and sellers in relation to the risk of entering into heads of agreement that are too detailed, exactly. And some bonus tips in relation to options and other tax things to be aware of.

Paula:
And it's remembering sometimes less is more,

Joanna:
less is more, what a great way to end it. Paula, thank you so much for coming onto the show today. And look if our we have any listeners out there who are preparing themselves for a sale of their business, and want to get some expert advice on tax and any of the areas that we're talking about today. Or just general preparations and understanding tax in the sale of their business. How did they get in contact with you Paula?

Paula:
They are welcome to phone me the full details are in the show notes or they can send me an email Ptallon@prosperity.com.au.

Joanna:
Brilliant, Okay, wonderful. You will find all of this in the show notes. So if you want to contact Paula, just head over to our show notes and you'll be able to get in contact with her there. Paula, thank you so much for coming back onto the show.

Paula:
Thank you, Joanna.

Joanna:
Well, that's it for this episode of the deal room podcast. If you'd like to find out more information about this topic, then head over to our website at the deal room podcast.com where you'll be able to download a transcript of this podcast episode if you're the kind of person who likes to read this stuff in detail. And of course there you will also find details of how to contact Paula Talon if you would like some assistance from a tax perspective with any of the deals that you're looking at right at the moment there you will also be able to find details of how to contact our Legal Eagles that aspect legal if you or your clients would like to discuss any legal aspects of sales or acquisitions. Now finally, if you enjoyed what you heard today, then don't forget to pop over to iTunes and leave us a review. Thanks again for listening in. You've been listening to Joanna Oakey and The Deal Room podcast, a podcast proudly brought to you by our commercial legal practice aspect legal. See you next time.