Income tax and gst implications of selling a business | case study

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Executive Summary

This report has been prepared for Fiona Chan, the sole shareholder of Fiona's Foods Limited, and is designed to inform Fiona of the tax implications (GST and Income Tax) relating to selling the shares versus selling the assets in Fiona's Foods Limited.

Fiona is GST registered and a New Zealand tax resident.

The following information will focus on the two options available to Fiona regarding selling her business. It will cover both the income tax implications and GST implications of selling the shares in Fiona's business or selling the assets. The differences will be presented in a table in the conclusion.

The recommendation will be based on research compiled, which included reading publications, articles, cases and tax legislation. The tax and GST implications of each option will then be investigated and presented.

This report is limited to income tax and GST implications only. No consideration for non-tax issues, imputations credits or dividends, or sale price is provided for.

Selling shares is usually the preferable choice for Vendors. When a business is sold by selling the shares, the proceeds of the sale are paid directly to the shareholder(s) of the company. The buyer then takes over control of the company including all responsibility for any risks the company may have now or in the future. (Finnigan, n. d.)

Generally, the proceeds of a sale of shares are tax exempt which will minimise tax issues for the vendor. (Finnigan, n. d.)

Most purchasers will prefer to purchase assets of a company, rather than shares. By selling the assets of the company it leaves the vendor with a company that can be used in the future, held for tax purposes, or liquidated.

Selling the company's assets involves selling some or all of its assets. This can include fixed assets such as land and buildings, plant and equipment and stock. It can also include intangible assets such as goodwill, intellectual property, etc. (Finnigan, n. d.)

Depending on what the objectives of each party are will determine what is involved with the asset sale. For example, a purchaser may only want to purchase the retail side of the business or specific assets such are specialised machinery. In this case, if the part sold cannot be operated as an independent separate business then GST will be charged with the part sale. (Finnigan, n. d.)

Based on the research completed and the information provided above I have come to the following conclusions.

Selling the shares in Fiona's company would not incur and GST as the sale would not be considered a taxable activity due to it not being the activity that the company does on a regular basis. It would also not be liable for GST as Fiona's shares are of an equity nature and therefore considered a financial service.

Selling the shares in Fiona's company would also not incur income tax. This is because the shares are of a capital nature and any amount derived from the sale of the shares would therefore not be liable for income tax. As New Zealand does not tax capital gains derived from the sale of investments, this also confirms that there would not be any income tax incurred.

As the assets and liabilities can be used outside of Fiona's company for a taxable activity, they would be considered a going concern. A going concern is considered zero-rated for GST purposes.

The sale of the assets and liabilities would incur income tax. The amount paid of the inventory would be considered income and liable for income tax. Also, any amount over and above the adjusted tax value at the date of the sale for the assets would be considered depreciation recovery income. That amount over the book value would incur income tax.

My recommendation for Fiona is to sell the shares in her business. Doing so means she will not be liable for GST or income tax on the sale allowing Fiona to maximise the amount she receives.

As Fiona no longer wants to keep the business, selling the shares would also allow for a clean break from the business as opposed to selling the assets, where Fiona would still have the shares in a Company which no longer had any assets or taxable activity.

Introduction

This report has been prepared for Fiona Chan, the sole shareholder of Fiona's Foods Limited, and is designed to inform Fiona of the tax implications (GST

and Income Tax) relating to selling the shares versus selling the assets in Fiona's Foods Limited.

Fiona is GST registered and a New Zealand tax resident.

The following information will focus on the two options available to Fiona with regard to selling her business. It will cover both the income tax implications and GST implications of selling the shares in Fiona's business or selling the assets. The differences will be presented in a table in the conclusion.

The recommendation will be based on research compiled, which included reading publications, articles, cases and tax legislation. The tax and GST implications of each option will then be investigated and presented.

This report is limited to income tax and GST implications only. No consideration for non-tax issues, imputations credits or dividends, or sale price is provided for.

Discussion

Option 1 – Selling the Shares

Selling shares is usually the preferable choice for Vendors. When a business is sold by selling the shares, the proceeds of the sale are paid directly to the shareholder(s) of the company. The buyer then takes over control of the company including all responsibility for any risks the company may have now or in the future. (Finnigan, n. d.)

Intangible assets are more likely to be transferred via a sale of company shares when they form a substantial portion of the asset value of the company. (Finnigan, n. d.)

Generally, the proceeds of a sale of shares are tax exempt which will minimise tax issues for the vendor. (Finnigan, n. d.)

When a company is sold by way of share sales the business the company does, is not affected. Employee relationships are not affected, the business continues as normal, and the ownership of the business remains with the company. Once the sale of shares has been completed the purchaser(s) will become the shareholder(s) of the company. (Finnigan, n. d.)

Section 8 of the Goods and Services Tax Act 1985 states that GST is to be applied to any goods or services that are supplied in New Zealand by a GST registered person in the course of their taxable activity. (Goods and Services Act, No 141, 1985)

Section 6 of the Goods and Services Tax Act 1985 states that a taxable activity is any activity that is carried out on a regular basis by any person, whether or not for economic profit. (Goods and Services Act, No 141, 1985)

As Fiona’s Company is in the business of importing Asian foods for distribution in New Zealand, this would be considered the Company’s taxable activity. As such the sale of shares falls outside the parameters of what would be considered the Company’s normal taxable activity, given the fact it is not an activity that it is carried out on a regular basis, and therefore, zero-rated for GST purposes.

Section 14 of the Goods and Services Tax Act 1985 states that the supply of financial service is exempt from tax. (Goods and Services Act, No 141, 1985)

According to Section 3 (1) (d), and for the purposes of the GST Act, the term financial service means the transfer or issue of ownership of an equity security or participatory security. (Goods and Services Act, No 141, 1985)

The shares Fiona owns in her company are considered equity and based on the abovementioned sections, Section 14 and Section 3, therefore selling the shares in the company would be exempt from GST as Fiona would be transferring the ownership of the equity in the company.

Under Section CB 3 of the Income Tax Act 2007, any profit that arises from carrying on or carrying out an undertaking or scheme is deemed to be income. (Income Tax Act, No 97, 2007)

Section CB 4 states that any amount obtained from disposing of personal property that was acquired with the intention of disposing of it is deemed to be income. (Income Tax Act, No 97, 2007)

According to Section CB 1 (1) any amount derived from a business is deemed income. However, Section CB 1 (2) states that if the income is of a capital nature then subsection 1 does not apply, and it is, therefore, exempt income. (Income Tax Act, No 97, 2007)

As Fiona’s shares in her Company are not of a personal nature Sections CB 3 and CB 4 do not apply. Also, due to the shares being of a capital nature, Section CB 1 (1) also does not apply.

There is the potential for capital gains tax, however in New Zealand, according to the Income Tax Act, Section CX 55 (2) (a), which states that the income derived from the disposal of shares in a company is exempt income, provided that the company fits into subsection 3, which according to subsection 3 the company needs to be a New Zealand tax resident. (Income Tax Act, No 97, 2007)

As Fiona's company is a New Zealand resident for tax purposes any amount derived from the sale of Fiona's shares in the business would not be liable for capital gains tax.

Option 2 – Selling the Assets

Most purchasers will prefer to purchase assets of a company, rather than shares. By selling the assets of the company it leaves the vendor with a company that can be used in the future, held for tax purposes, or liquidated. If the company is solvent and liquidated, then this allows for the company profits to be distributed tax exempt. If the company is insolvent and liquidated, then this allows an independent party to come in and ensure that any creditors are paid in the correct priority and order. (Finnigan, n. d.)

Selling the company's assets involves selling some or all of its assets. This can include fixed assets such as land and buildings, plant and equipment and stock. It can also include intangible assets such as goodwill, intellectual property, etc. (Finnigan, n. d.)

Depending on what the objectives of each party are will determine what is involved with the asset sale. For example, a purchaser may only want to purchase the retail side of the business or specific assets such are

specialised machinery. In this case, if the part sold cannot be operated as an independent separate business then GST will be charged with the part sale. (Finnigan, n. d.)

When a company sells assets the proceeds of the sales are paid directly to the company. Once creditors have been paid the shareholder(s) are able to remove the balance of the proceeds. If the company has insufficient funds the shareholder(s) will be left with a company that needs to be liquidated in order to settle any disputes or liabilities the company may have. If the company is able to clear all debts, then the capital gain is extracted by the shareholder(s) and is tax-free.

According to Section 11 (1) (m) of the Goods and Services Tax Act, the supply of goods that would normally be taxable must be zero-rated when those goods are supplied to a registered person of a taxable activity or part thereof, and the supplier and recipient both agree in writing that the supply is a going concern and is capable of continuing to be a going concern. (Goods and Services Act, No 141, 1985)

To be considered a going concern, there must be a supply of a taxable activity or part thereof which is capable of operating separately from the business. Also, everything required for the continual operation or part thereof, of the taxable activity needs to be supplied to the purchaser. Lastly, the supplier needs to be carrying on the taxable activity continuously until the time it is transferred to the purchaser. (Coleman, et al., 2019)

As the assets and liabilities of Fiona’s Company are required for the company to continue its taxable activity, selling the assets and liabilities would be

considered as selling a going concern and as long at it is agreed in writing with the purchaser. The assets and liabilities would, therefore, be exempt from GST.

Section CB 2 of the Income Tax Act 2007 states that when a person owns or carries on abusiness and sells some or all of the assets pertaining to that business, and the sale is made to put an end to the business, plus the sale includes inventory, then the amount derived from the sale of the inventory is considered income and would, therefore, incur tax. (Income Tax Act, No 97, 2007)

The assets in Fiona's company contains inventory and therefore the sale price of the inventory would incur income tax.

Section EB 24 of the Income Tax Act states that the sale price of the assets needs to be apportioned at the fair market value between the fixed assets and the inventory. The amount apportioned to the inventory is deemed the price paid for it by the purchaser. (Income Tax Act, No 97, 2007)

Also, in the Income Tax Act, Section EE 48 states that any amount derived from the sale of the assets which is over and above the adjusted tax value of the asset on the date of the sale is deemed to be depreciation recovery income. (Income Tax Act, No 97, 2007) This income is liable for income tax.

Conclusion

Option 1 – Selling the Shares

Based on the research completed and the information provided above I have come to the following conclusions.

GST Implications

Selling the shares in Fiona's company would not incur and GST as the sale would not be considered a taxable activity due to it not being the activity that the company does on a regular basis. It would also not be liable for GST as Fiona's shares are of an equity nature and therefore considered a financial service.

Income Tax Implications

Selling the shares in Fiona's company would also not incur income tax. This is because the shares are of a capital nature and any amount derived from the sale of the shares would therefore not be liable for income tax. As New Zealand does not tax capital gains derived from the sale of investments, this also confirms that there would not be any income tax incurred.

Option 2 – Selling the Assets

GST Implications

As the assets and liabilities can be used outside of Fiona's company for a taxable activity, they would be considered a going concern. A going concern is considered zero-rated for GST purposes.

Income Tax Implications

The sale of the assets and liabilities would incur income tax. The amount paid of the inventory would be considered income and liable for income tax. Also, any amount over and above the adjusted tax value at the date of the sale for the assets would be considered depreciation recovery income. That amount over the book value would incur income tax.

Table – Summary of GST and Income Tax Implications

	GST Implications	Income Tax Implications
Sale of Shares	None – Per Sections 3, 6, 8 and 14 of the GST Act	None – Per Sections CB1, CB3, CB4 & C the Income Tax Act
Sale of Assets	None – Per Section 11 of the GST Act	Liable for Income Tax – Per Sections C EE48

Recommendation

My recommendation for Fiona is to sell the shares in her business. Doing so means she will not be liable for GST or income tax on the sale allowing Fiona to maximise the amount she receives.

As Fiona no longer wants to keep the business, selling the shares would also allow for a clean break from the business as opposed to selling the assets, where Fiona would still have the shares in a Company which no longer had any assets or taxable activity.

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