CORPORATE M&A

INDIRECT TAX SHARING AGREEMENTS
- ESSENTIAL RISK MANAGEMENT TOOL

M&A activity continues to provide opportunities for growth in the post GFC climate, despite some continuing volatility and the imminent Federal election.

It has become commonplace for companies in a corporate group to consolidate for tax purposes. Whether you are buying or selling a company that is part of a tax consolidated group, there are very important considerations to bear in mind regarding the treatment of tax liabilities.

Recently enacted legislation relating to ***Indirect Tax Sharing Agreements*** (**ITSAs**) will result in ITSAs becoming an essential part of any due diligence exercise.

Effective due diligence

Central to any M&A transaction is effective risk management. Purchasers are keen to ensure that they understand what they are buying into. Vendors, keen to secure the maximum price, strive to provide comfort to the purchaser without compromising their own position.

Due diligence is the key process in which risk is identified. This process involves an investigation into all facets of the target company including financial, legal and tax. Vendors should conduct a thorough vendors' due diligence before the company is offered for sale, so that they can mitigate risks and present the company for sale in the best light. Purchasers will conduct detailed due diligence once the company is offered for sale, to identify risks. Tax related risks are always a key area of investigation.

Managing income tax risk exposure

Special considerations arise where a target is exiting a tax consolidated group. In these circumstances, the due diligence process ought to identify whether a tax sharing agreement (**TSA**) has been in place for the target's membership period.

The absence of a valid TSA is a potential deal breaker. Without a valid TSA, the purchaser is jointly and severally liable for the income tax liabilities of the target's former group for any period the target was a member of that group. This includes undisclosed and unknown tax liabilities (which may be unknown to the vendor).

The result - substantial exposure for the purchaser. While a purchaser may obtain an indemnity from the vendor against such exposure, it is always better to identify and avoid risks and not to enter into a transaction in the expectation of having to rely on an indemnity to recoup a tax liability. Similarly, a vendor will not want to sell a company knowing there is a real risk of an indemnity claim after completion.

Getting the tax risks under control is therefore in the interests of both the vendor and the purchaser.

Managing indirect tax risk exposure

Through a TSA, a purchaser of a target who is exiting a tax consolidated group can significantly limit its potential *income* tax exposure. However, a purchaser has not, until now, been able to limit its exposure to *indirect* tax liabilities such as GST. That is, purchasers have been jointly and severally liable for the indirect tax liabilities of the target's former GST Group.

From 1 July 2010, members of a GST Group are able to enter into an ITSA. An ITSA, like a TSA, allows a purchaser to limit its potential exposure by:

- Removing joint and several liability and limiting the target's exposure to an amount determined under the ITSA (for the GST tax periods when the ITSA was in place); and

- Allowing the target to exit the group clear of any indirect tax liabilities for the periods covered by the ITSA.

Cowell Clarke view the introduction of the ITSA legislation as a much welcomed reform. As with a TSA, the existence of an ITSA will become an integral part of managing the due diligence on M&A transactions and mitigating risk for future sales and mergers.

To maximise the benefit of the ITSA, we recommend that corporate groups have ITSAs that are effective from the lodgement date of their July BAS - 21 August 2010 - or as soon as possible after that date.

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