TR 96/24 - Income tax: capital gains: guidelines to determine whether an amount described in a sale of business agreement as consideration for goodwill is properly characterised as a lease premium

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Taxation Ruling

Income tax: capital gains: guidelines to determine whether an amount described in a sale of business agreement as consideration for goodwill is properly characterised as a lease premium

*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

contents	para
What this Ruling is about	**1**
Class of person/arrangement	1
Previous Rulings	**6**
Ruling	**7**
Date of effect	**13**
Explanations	**14**
Legislation	14
Case 51/94; AAT Case 9774	*16*
FC of T v. Krakos Investments Pty Ltd	*18*
Sham	21
Characterisation of transaction	25
The form of the document	29
Market value rentals	30
Significance of the put option	34
Examples	**40**

What this Ruling is about

Class of person/arrangement

1. This Ruling applies to a vendor who is selling a business and who is also granting a lease of the premises on which the business is conducted. It considers whether an amount described as consideration for the sale of goodwill in a sale of business contract should be properly characterised, for capital gains tax purposes, in whole or in part, as a premium received on the grant of the lease. The Ruling applies, for example, to the grant of a lease over a hotel, newsagency, service station, motel, restaurant or fast-food outlet.

2. The characterisation of an amount as a lease premium or consideration for goodwill has implications under the capital gains tax provisions of the income tax law (Part IIIA of the *Income Tax Assessment Act 1936*). If the amount represents consideration in respect of the disposal of goodwill, the partial exemption in section 160ZZR for a capital gain on a disposal of goodwill may apply. If the amount represents a lease premium, section 160ZS requires the amount of the consideration, less any cost base, indexed cost base or reduced cost base in respect of the grant of the lease, to be taken into account in determining a capital gain or capital loss.

3. This Ruling does not explore in detail what goodwill is, but focuses on the relevant factors in determining whether any or all of the consideration allocated to goodwill constitutes a lease premium. If the consideration allocated to goodwill is not a lease premium it

should not be assumed that this amount will automatically be accepted as being a receipt in respect of goodwill. We will be releasing our views on what constitutes goodwill in a later Taxation Ruling.

4. It is, therefore, feasible that an amount described by parties to a sale of business agreement as consideration for goodwill is, when properly characterised, neither consideration for goodwill nor a lease premium. The amount could represent something else such as a lease rental, a prepayment of lease rentals, money or other consideration in terms of subsection 160M(7) or a profit margin. It is not the purpose of this Ruling to consider these other possible characterisations.

5. For the purposes of this Ruling the term 'lease' should be taken to include a reference to the granting of either a lease or sublease by the vendor of the business. A reference to the term 'lessor' should be read as a lessor who has disposed of a business to a lessee.

Previous Rulings

6. This Ruling considers the decision of the Full Court of the Federal Court of Australia in *FC of T v. Krakos Investments Pty Ltd* 96 ATC 4063; (1995) 133 ALR 545 (*Krakos* case). Taxation Ruling IT 2535, issued in May 1989, is inconsistent with that decision. Taxation Ruling IT 2535 is replaced by this Ruling and is now withdrawn.

Ruling

7. A sum is a lease premium if it is received as consideration for the grant of a lease. The expression 'lease premium' is used here in contradistinction to 'rent' which is the consideration payable under a lease for the right to use and occupy the leased premises during the term of the lease.

8. When a business is sold an amount may be described by the parties as consideration for goodwill in the sale of business agreement. If the vendor of the business is also granting a lease of the premises, all of the relevant circumstances, including the terms of the sale of business and lease agreements, must be taken into account in determining whether this amount should be properly characterised, in whole or in part, as a lease premium.

9. The terms of the sale of business and lease agreements entered into by a lessor and a lessee are important, although not necessarily decisive, in determining whether an amount received by the lessor is properly characterised as a lease premium. It is not determinative of

the issue that the parties describe the amount the lessor receives as consideration for the disposal of goodwill, rather than a lease premium. A Court will look to the true nature of transactions between the lessor and the lessee, and is not bound by the label which the lessor and lessee attribute to the transactions.

10. If, however, the true nature of the receipt on the sale of a business is ambiguous, as it often is in distinguishing between consideration for goodwill and a lease premium, we accept that this ambiguity can be removed in most cases by the very agreements the lessor and lessee make with one another. In most cases, therefore, if the lessor and the lessee in their agreements describe a receipt as being consideration for goodwill, rather than for the grant of the lease, we will accept that the consideration does not constitute a lease premium. We say 'in most cases', because the label the lessor and lessee give to a receipt cannot be given much or any weight in determining whether the receipt is a lease premium, if:

(i) the agreement between the parties is a sham; or

(ii) market value rentals are not charged throughout the duration of the lease; or

(iii) the lessor and lessee (whether or not they are arm's length parties) are not dealing with each other on an arm's length basis in allocating consideration to assets which are disposed of when the business is sold.

11. If any of subparagraphs 10(i) to (iii) of this Ruling apply, we may, depending on the particular facts involved, seek to characterise the receipt or part of the receipt as a lease premium. If doubt arises as to whether an amount is a lease premium, we will also take into account any put option of the kind which existed in the *Krakos* case, in determining the true nature of the receipt.

12. We no longer take the view (which we previously took in Taxation Ruling IT 2535) that any receipt by a lessor for site (local) goodwill is automatically a lease premium for capital gains tax purposes. This view was based on the notion that site goodwill could not be disposed of to a lessee because it is inseverable from the business premises. We accept that this view can no longer be sustained.

Date of effect

13. This Ruling, which is inconsistent with and more favourable to taxpayers than Taxation Ruling IT 2535, applies for years of income commencing both before and after the date on which this Ruling is issued (subject to the statutory limits of section 170).

Explanations

Legislation

14. For the capital gains and capital losses provisions, the grant of a lease of property is not taken to be a part disposal of the property. By subsection 160ZS(1), the grant is deemed to constitute the disposal by the lessor to the lessee of an asset (being the lease) created by the lessor for a consideration equal to the premium paid or payable for the grant of the lease. Subsection 160ZS(2) specifies that the relevant cost base to the lessor of the lease comprises only the amounts of expenditure incurred in respect of the grant of the lease.

15. Paragraph (aa) of the definition of 'asset' in section 160A includes 'goodwill'. Goodwill associated with a business which commenced before 20 September 1985 has no capital gains or capital losses consequences on its disposal. A capital gain arising from the disposal of goodwill associated with a business which commenced on or after 20 September 1985 may qualify for partial exemption under section 160ZZR. This section reduces the capital gain by 50% on the disposal of goodwill or an interest in goodwill when a business or an interest in a business is disposed of, if the net value of the business is less than the exemption threshold. The exemption threshold for the 1996-97 year of income is $2,204,000.

Case 51/94; AAT Case 9774

16. The issue whether an amount constitutes a lease premium or consideration for goodwill was considered in *Case 51/94* 94 ATC 447; *AAT Case 9774* (1994) 29 ATR 1161. In that case, a partnership purchased a freehold property which included a motel. The partnership paid a separate amount for goodwill. The motel was then leased by the partnership and the lessee paid the partnership an amount for the goodwill of the business.

17. After examining case law, the Administrative Appeals Tribunal Deputy President, Dr P Gerber, concluded (94 ATC at 457; 29 ATR at 1173) that a lease premium in terms of section 160ZS 'is a sum paid as consideration for the grant of a lease'. Dr Gerber took the following factors into account in determining that the amount in question was not a lease premium:

(a) both the purchase and disposal of the motel business by the partnership (lessor) were undertaken by way of 'effective, arm's length and bona fide' agreements (94 ATC at 459; 29 ATR at 1176); and

(b) the contractual apportionment of the purchase price was bona fide (94 ATC at 459; 29 ATR at 1176); and

(c) nothing in the evidence suggested 'that the rental payable under the lease was other than market value' (94 ATC at 459-460; 29 ATR at 1176).

FC of T v. Krakos Investments Pty Ltd

18. In *FC of T v. Krakos Investments Pty Ltd* 96 ATC 4063; (1995) 133 ALR 545, the taxpayer acquired land and built a hotel on that land. After trading for several years, the company sold the hotel business, leased the hotel premises and transferred the hotel licence to the lessee. An amount of $420,000 was paid for goodwill in accordance with the agreement.

19. The Full Federal Court considered whether the amount paid for goodwill was a premium paid or payable for the grant of a lease. The parties in the *Krakos* case agreed as to the proper test to apply in determining whether a receipt is to be characterised as a premium for the grant of a lease (96 ATC at 4074; 133 ALR at 558):

> 'A sum will be a premium where it is paid as consideration for the grant of the lease. The expression is used in contradistinction to rent which is the consideration payable under the lease for the right of use and occupation of the leased premises during the term of the lease.'

20. In determining that the amount in question was not a lease premium the court took into account the following factors:

(a) the form of the document (96 ATC at 4068 and 4074; 133 ALR at 551 and 558); and

(b) the agreement was not a sham (96 ATC at 4075; 133 ALR at 559); and

(c) the rental payable under the lease was not less than a market rental (96 ATC at 4075; 133 ALR at 559); and

(d) the existence of a put option in the contract which allowed the purchaser of the business (lessee) to require the vendor (lessor) to buy back the goodwill at the end of the initial term of the lease for a consideration equal to the amount paid by the lessee for the goodwill (96 ATC at 4075; 133 ALR at 559-560).

Sham

21. If the receipt is to be accepted at face value as not constituting a lease premium the arrangement must not constitute a sham. This is a

relevant factor which was considered in the *Krakos* case, where the Court stated (96 ATC at 4075; 133 ALR at 559):

> 'The present, it must again be said, is not a case where it was suggested that the agreement was a sham. While there is no evidence that the parties themselves bargained specifically for the apportionment of the purchase price adopted, that apportionment was determined by the accountant for Krakos and by signing the agreement adopted by Krakos.'

22. For an act, document or transaction to be a sham, there must be a common intention of the parties to it that the act, document or transaction is not to create the legal rights and obligations which it gives the appearance of creating: *Snook v. London and West Riding Investments Ltd* (1967) 2 QB 786 per Diplock LJ at 802 and *Faucilles Pty Ltd v. FC of T* 90 ATC 4003 at 4025; (1989) 20 ATR 1712 at 1736; *Richard Walter Pty Limited v. FC of T* 96 ATC 4550 at 4552; (1996) 33 ATR 97 at 99.

23. In the *Richard Walter* case the Full Federal Court held that the taxpayer had not discharged the burden of proving the assessment to be excessive. The taxpayer had not been able to prove that the payments in question were loans and could not establish that the payments should be characterised otherwise than as income. Lockhart and Hill JJ reviewed the meaning of the word 'sham' in their respective judgments and Hill J defined 'sham' in the following way (96 ATC at 4562; 33 ATR at 110):

> 'A common intention between the parties to the apparent transaction that it be a disguise for some other and real transaction or for no transaction at all.'

24. The incorrect labelling of consideration as goodwill by the parties in a sale of business agreement, for the purpose of masking a lease premium paid by a lessee, may therefore constitute a sham.

Characterisation of transaction

25. If the agreement between the parties is not a sham, regard must be had to the legal rights which arise pursuant to the transaction. The Full Federal Court adopted this approach in *Australia and New Zealand Savings Bank Ltd v. FC of T* 93 ATC 4370; (1993) 114 ALR 673. In the *ANZ* case, the Court had to determine whether the transaction was a loan with payments of principal and interest, or whether the contract was for an annuity, or insurance. In attempting to determine the correct characterisation of the transaction, Hill J made the following statement (93 ATC at 4389; 114 ALR 673 at 697-698):

> 'In the absence of a submission that the transaction entered into by the parties is a sham, a disguise for some other and different transaction, and in the absence of the application of the anti-avoidance provisions of Part IVA of the Act, the Court must look to see what the transaction entered into by the parties by its terms effects. That is to say, regard must be had to the legal rights which the transaction actually entered into confers. Invocation of the doctrine of substance is of no assistance in this task.'

26. Notwithstanding the description or labelling of an amount as goodwill in an agreement the Full Federal Court made the point in the *Krakos* case that it will look beyond the label in characterising a transaction (96 ATC at 4068; 133 ALR at 550):

> 'It is, of course, true that the court will not be bound by the label which the parties have attributed to a particular transaction.'

27. However, after reviewing relevant case law, the Federal Court said in the *Krakos* case (96 ATC at 4068; 133 ALR at 551):

> 'Thus, in a case where no question of sham is suggested, and it is not suggested that the label used is not a genuine statement of the parties' intention, that label will be given its proper weight.'

28. In summary, where the parties have misdescribed certain consideration in a sale of business agreement as goodwill, whereas it true nature is a lease premium, we will give the consideration its correct characterisation in accordance with the tenor and effect of the relevant documentation.

The form of the document

29. The form of the agreement between the parties can be an important factor in determining whether an amount is a lease premium. The form of the agreement in the *Krakos* case was influential in the Federal Court reaching its decision, as the following quotation evidences (96 ATC at 4074; 133 ALR at 558):

> '... in the decided cases the distinction [between rent and premium] seems often to turn on matters of form rather than matters of substance. That gives additional significance to the form which the parties in their bargain adopted, namely, that the payment made was consideration for goodwill, rather than for the grant of the lease.'

Market value rentals

30. After concluding that the agreement was not a sham in the *Krakos* case, Hill J examined the rentals payable under the lease (96 ATC 4063 at 4075; 133 ALR 545 at 559):

> 'The present is also not a case where the rental payable under the lease was lower than a market rental. This was a matter explored in evidence through the testimony of a valuer called by the Commissioner who took the view that, if anything, the purchaser was required to pay more than the market value rent.'

31. It is our view that the payment of lease rentals, which are below market value, is relevant in determining the legal rights conferred by the transaction in the sense referred to in the *ANZ* case. Below market value rentals may therefore indicate that all or a part of the consideration paid for the goodwill of a business is in effect a lease premium.

32. We recognise and accept that a lessor and lessee may agree to a rental which is less than what would generally be considered to be in the range of market value rentals and that there may be legitimate commercial reasons for the setting of such a rental.

33. In these circumstances, the basis of valuing and allocating an amount of consideration to goodwill would require close examination. If an amount allocated to goodwill is excessive in order to reduce lease payments, we take the view that some part of the consideration paid for the goodwill may constitute a lease premium. Alternatively, in these circumstances, all or part of the amount allocated to goodwill may constitute a prepayment of lease rentals. The burden of proving the basis and reasonableness of apportionment in allocating an amount to goodwill and other assets remains with the lessor (96 ATC at 4075; 133 ALR at 559).

Significance of the put option

34. A put option is another relevant factor in determining the legal rights conferred by a transaction. The court had the following to say in relation to the put option in the *Krakos* case (96 ATC at 4075; 133 ALR at 559-560):

> 'The conclusion that the payment in the present case is not to be characterised as a "premium" is facilitated by the provisions of special condition (2), set out earlier in these reasons, which provided an obligation on Krakos to buy back the goodwill, if required by the purchasers so to do, and to pay, subject to the terms of the clause, $420,000 for it. If the $420,000 presently in dispute was a premium or the consideration for the grant of the lease, once paid it would not be returnable. Yet the parties have

bargained for a put option, pursuant to which that amount may come to be repaid to the purchasers at the expiration of the lease. That is inconsistent with the amount of $420,000 being treated as a premium, ie as consideration for the grant of the lease.'

35. The existence of a put option in the *Krakos* case assisted the Court to reach its decision that the amount received by the lessor was not a lease premium.

36. A put option that requires a lessor to repay, at the expiration of a lease, an amount ostensibly received for goodwill is therefore relevant in determining whether the amount should be characterised as consideration for the grant of the lease, and thus, as a lease premium.

37. If none of subparagraphs 10(i) to 10(iii) above applies, the existence of such a put option would strengthen the view that an amount is not a lease premium. To conclude that a receipt should not be characterised as a lease premium, it is not essential, however, that a put option exists. We will accept that an amount, ostensibly received in respect of goodwill, should not be characterised as a lease premium provided that subparagraphs 10(i) to 10(iii) do not apply.

38. If the agreement between the parties is a sham (i.e., subparagraph 10(i) applies) we take the view that the existence of a put option carries little, if any, weight.

39. If the agreement is not a sham and subparagraph 10(ii) or 10(iii) applies, or both apply, the significance of the put option is reduced. In these circumstances, we would take the put option into account, albeit to a reduced extent, in determining whether any or all of the amount described as goodwill should be characterised as a lease premium.

Examples

Example 1

40. Alan leases a hotel to Brenda and Alan (the lessor) receives an all inclusive lump sum amount of $500,000 from Brenda (the lessee). The lump sum is claimed to be made up of plant and equipment and goodwill although Alan and Brenda made no formal apportionment. These assets are listed in the business sale agreement. A put option in relation to goodwill is not granted to Brenda. Brenda is not restricted from selling the business and its goodwill at any time during the lease. The annual lease rental is $105,000. After a review of the valuation reports, it is established that an annual market value rental for the lease should range between $100,000 and $120,000.

41. Weight in the *Krakos* case was given to the fact that the parties had described the consideration as goodwill. Although the parties here have not allocated a specific amount to goodwill in their sale agreement, goodwill is listed as one of the assets which have been disposed of by the vendor. If Alan later allocated market value amounts to each of the assets (including goodwill) which are disposed of to Brenda, with the result that no part of the $500,000 remains unallocated, we would accept that no part of the lump sum constitutes a lease premium.

Example 2

42. Nisha, a newsagent, decides to sell her pre-capital gains tax business to Tasha for a consideration of $500,000. An amount of $100,000 is allocated to stock and an amount of $400,000 to goodwill. Nisha does not own the newsagent shop, having obtained the premises under lease. Nisha and Tasha decide to enter into an arrangement whereby Nisha subleases the newsagency to Tasha for five years. Tasha has the same rights as Nisha is entitled to under her lease ('headlease'). Annual rentals under the headlease are $40,000 per annum and a valuer confirms that the annual rental payment is a market value rental. The valuer, who specialises in valuing newsagencies, states that the market value of the newsagency's goodwill is between $300,000 and $330,000. The sublease provides for an annual rental of $10,000.

43. After being asked why she is prepared to lose so much money on the lease, Nisha states that she had pressing financial needs at the time. She was prepared to be generous on the lease rentals to raise the amount she would receive from Tasha.

44. The vendor of the newsagency business, Nisha, is not deriving a market rental for the sublease which is $40,000. Nisha will lose $150,000 over the five year period on her subleasing activities. We consider that an excessive amount of consideration has been allocated to goodwill. Part of the $400,000 consideration for goodwill could be characterised as either a lease premium or a prepayment of rental expenses.

Example 3

45. Sad Pty Ltd (Sad) is granted a lease of a motel for which no consideration is paid and acquires plant and equipment. After trading for several years, Sad subleases the motel to Lad Pty Ltd (Lad) and Lad pays an amount of $100,000 to Sad. The contract states that the $100,000 consideration is paid for the right to underlease. The agreement makes no reference to goodwill. The agreement requires

the headlessor to agree to the terms of the underlease, which is obtained. The contract prevents Lad from using Sad's trading name 'Sleep Tight Motel'.

46. The form of the agreement does not suggest that the payment is for goodwill. The two amounts are received as consideration for the disposal of an asset and subsection 160ZS(1) or subsection 160M(6) applies.

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- ITAA 160M(6)
- ITAA 160M(7)
- ITAA 160ZS
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- ITAA 160ZZR
- ITAA 170

case references
- Australia and New Zealand Savings Bank Ltd v. FC of T 93 ATC 4370; (1993) 114 ALR 673
- Faucilles Pty Ltd v. FC of T 90 ATC 4003; (1989) 20 ATR 1712
- FC of T v. Krakos Investments Pty Ltd (1995) 133 ALR 545; 96 ATC 4063
- Richard Walter Pty Limited v. FC of T 96 ATC 4550; (1996) 33 ATR 97
- Snook v. London and West Riding Investments Ltd (1967) 2 QB 786
- Case 51/94 94 ATC 447; AAT Case 9774 (1994) 29 ATR 1161