


TD 2006/D43 - Income tax: consolidation: in working out the market value of the goodwill of each business of an entity that becomes a subsidiary member of a consolidated group, should the value of related party transactions of each business of the entity be recognised on an arm's length basis?

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This document has been finalised by This Draft Ruling has been finalised by TD 2007/1.



Draft Taxation Determination

Income tax: consolidation: in working out the market value of the goodwill of each business of an entity that becomes a subsidiary member of a consolidated group, should the value of related party transactions of each business of the entity be recognised on an arm's length basis?

❶ This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the way explained below. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. Yes. The market value of the goodwill of a business of an entity (a business) that becomes a subsidiary member of a consolidated group (the joined group) at the joining time is usually worked out by applying the residual value approach (see paragraph 10 of this Determination). This market value is equal to the sum of the differences between the market value of each business of the entity and the market value of the net identifiable assets of each business of the entity. For the purposes of applying the residual valuation approach, the market value of each business, and each asset and liability of the entity is worked out on the basis that the entity has engaged in arm's length dealings.

2. In order to determine a market value of the goodwill of a business that is a party to an arrangement that is not on an arm's length basis, transactions relevant to the valuation of the business must be adjusted to an arm's length basis. This is a principle of general application that also applies to the valuation of other commercial or business assets and liabilities where cash flow is relevant to a valuation. The principles set out in Taxation Ruling TR 97/20 apply to establish an arm's length outcome.

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3. Obtaining a market valuation on an arm's length basis for the purposes of applying a statutory provision requires a market for the asset to be hypothesized, consisting of all hypothetical buyers and sellers who could reasonably be expected to be interested in buying or selling the asset. The market value is the value that such hypothetical buyers and sellers would arrive at to achieve a notional sale.

4. Adjustments to establish an arm's length outcome should be made to all such transactions with the limited exception of those carried out under binding legal agreements in circumstances where it would be commercially realistic that the entity in question would be disposed of by the economic group to an unrelated party with such an agreement in place.

Example

5. *H Co is the head company of a consolidated group. H Co purchases 100% of the membership interests in A Co and 100% of the membership interests in B Co. Prior to consolidation A Co and B Co were both owned by C Co. A Co carries on business producing machinery parts that are used in B Co's manufacturing business. A Co sells machinery parts to B Co at less than market value. At the joining time both A Co and B Co had goodwill in their respective businesses.*

6. *In this case A Co and B Co did not deal with each other at arm's length. When working out the market value of the respective businesses of A Co and B Co for the purposes of calculating their goodwill, H Co may need to make adjustments to the actual cash flows of these entities to ensure that the market values reflect arm's length dealings based on the principles outlined in TR 97/20.*

Date of effect

7. When the final Determination is issued, it is proposed to apply to years commencing both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination.

Commissioner of Taxation

20 September 2006

Appendix 1 – Explanation

❶ ***This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.***

Explanation

8. When an entity joins a consolidated group, the tax cost of its assets (including goodwill) is set at the tax cost setting amount under Division 705 of the *Income Tax Assessment Act 1997* (ITAA 1997) unless the head company chooses the transitional option to retain existing tax values for the entity’s assets (section 701-5 of the *Income Tax (Transitional Provisions) Act 1997*). The tax cost setting amount for each asset (except retained cost base assets and excluded assets) is worked out under subsection 705-35(1) of the ITAA 1997 by finding the difference between the joined group’s allocable cost amount for the entity and the total of the tax cost setting amounts for retained cost base assets (which must not be less than zero) and allocating the result to each reset cost base asset (other than excluded assets) in proportion to its market value.

9. Goodwill of an entity is a reset cost base asset and its tax cost is set under subsection 705-10(4) or subsection 705-35(3) of the ITAA 1997. For consolidation purposes, the goodwill (if any) of an entity is identified under the residual value approach as the sum of the differences between:

- (a) the market value of each business of the entity; and
- (b) the market value of the net identifiable assets of each business of the entity.

(Taxation Ruling TR 2005/17 paragraph 7).

10. The residual value approach is consistent with the approach accepted in the majority judgment in *Federal Commissioner of Taxation v. Murry* (1998) 193 CLR 605; (1998) 98 ATC 4585; (1998) 39 ATR 129. The residual value approach is an appropriate method to work out the goodwill of a business of an entity that is profitable and is expected to continue to be profitable. If the business is not profitable or has less than industry average profitability, a different approach may be appropriate (Taxation Ruling TR 1999/16 at paragraphs 47 to 49).

11. Market value is not defined for consolidation purposes. In *Spencer v. Commonwealth* (1907) 5 CLR 418 Griffith CJ (at page 432) said that the value of land on a given day is determined by inquiring what a person desiring to buy the land would have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell.

12. In *Capricorn Diamonds Investments Pty Ltd v. Catto and Ors* [2002] VSC 105 (10 April 2002) the following definition, given in evidence, was referred to approvingly by the court at paragraph 177:

Fair market value is commonly defined as the price that would be negotiated in an open and unrestricted market between a willing, knowledgeable, but not anxious buyer and a willing, knowledgeable but not anxious seller, acting at arm’s length.

13. Lonergan¹ provides an almost identical definition at page 766:

Market Value – The price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller acting at arm's length.

14. In *Granby Pty Ltd v. Federal Commissioner of Taxation* (1995) 129 ALR 503 at 506-507; (1995) 95 ATC 4240; (1995) 30 ATR 400 Lee J said that the term 'at arm's length' means at least that the parties to a transaction acted severally and independently in forming their bargain. Both the relationship between the parties and their conduct in forming the transaction are relevant to whether they have dealt with each other at arm's length. If parties are at arm's length then it usually follows that they will have dealt with each other at arm's length.

15. It is conventional valuation practice when valuing a business or entity to adjust to an arm's length basis transactions between related parties that have not been carried out at arm's length. To achieve an arm's length outcome in the valuation of a business of an entity, valuers adjust transactions made on a non-arm's length basis, to an arm's length basis. Lonergan, at page 36, notes that the following adjustments would usually be made in working out future maintainable profits for the purpose of valuing a business of an entity:

- non-arm's length transactions such as excessive (or inadequate) directors' remuneration and personal expenses...
- Abnormal, extraordinary or significant items...

16. Similar views are expressed in the Australian Valuation Handbook² at paragraph 8-1350:

Some of the 'unusual transactions' that we have adjusted for in the past have included:

- sales (where inter-business transfers have occurred at non-arm's length prices or where they may not occur in the future);
- other non-arm's length transactions at above or below market rates;

17. Evidence of commercial business practice in Australia in determining asset values can also be found in accounting standards issued by the Australian Accounting Standards Board. Under accounting standards in force from 1 January 2005 the carrying amount of goodwill is subject to the results of an annual valuation referred to as impairment testing carried out at the level of the smallest viable business unit known as a cash-generating unit. The basis on which impairment testing is carried out is governed by Accounting Standard AASB 136 *Impairment of Assets*.

18. AASB 136 provides guidance on the treatment of internal transfer pricing when working out the value of goodwill for the purpose of impairment testing as follows:

70. If an active market exists for the output produced by an asset or group of assets, that asset or group of assets shall be identified as a cash-generating unit, even if some or all of the output is used internally. If the cash inflows generated by any asset or cash-generating unit are affected by internal transfer pricing, an entity shall use management's best estimate of future price(s) that could be achieved in arm's length transactions in estimating:

- (a) the future cash inflows used to determine the asset's or cash-generating unit's value in use; and
- (b) the future cash outflows used to determine the value in use of any other assets or cash-generating units that are affected by the internal transfer pricing.

¹ Lonergan, W 2003, *The Valuation of Businesses, Shares and Other Equity* (4th ed.), Allen and Unwin, NSW.

² Thomson CPD Business Solutions <www.taxpoint.com.au>.

19. Applying valuation principles to arrive at the market value of a business of an entity for the purposes of any statutory provision, including for consolidation purposes, requires that the market value of each business of the entity is worked out on the basis that the entity's dealings are on an arm's length basis. Prior to consolidation, entities within wholly owned groups may not have dealt with each other at arm's length and as a result the value of a business of an entity, worked out by reference to unadjusted transactions it has engaged in, may not reflect its market value.

20. If a business has engaged in intragroup transactions that are not at arm's length, cash flows or the absence of cash flows need to be adjusted to represent arm's length dealings and any adjustments should reflect the principles set out in TR 97/20. This applies to the basic case and formation case where the entities are valued on a standalone basis. If businesses within a joined group have synergistic goodwill as a result of their relationship with each other, that goodwill should be reflected in the adjusted cash flows, and hence the market value, of those businesses.

21. The arm's length outcome is what would have happened if the ownership link between the non-arm's length entities was severed and each entity was motivated by its own economic interests (TR 97/20 at paragraph 2.5). TR 97/20 sets out methods that are used to establish an arm's length outcome in cases where that outcome cannot be reliably determined from the information available. The arm's length outcome is a benchmark against which the non-arm's length outcome is compared and adjusted if necessary. Although TR 97/20 deals with international dealings the same principles and methods are applicable to valuing businesses of joining entities in consolidation.

22. Obtaining a market valuation on an arm's length basis for the purposes of applying a statutory provision requires a market for the asset to be hypothesized.³ This is required even where no such market exists at the valuation date because, for example, there are no actual buyers or sellers actually seeking to buy or sell on that date.⁴

³ This is implicit, for example, in the decision in *Spencer v. The Commonwealth* (1907) 5 CLR 418: refer Marks B, 'Valuation Principles in the Income Tax Assessment Act', (1996) 8 Bond LR 114 at 120.

⁴ See for example *Spencer v. The Commonwealth* (1907) 5 CLR 418 at 432, where Griffith CJ states: '...but there may be no one actually willing to buy it at any price. Still it does not follow that the land has no value ... In my judgement the test of value of land is to be determined, not by inquiring ... whether there was in fact on that day a willing buyer ...'.

23. The hypothetical market is one that consists of all hypothetical market participants who could reasonably be expected to be interested in buying or selling the asset.⁵ A factor which influences the nature and extent of such a market is the use to which an asset may be put.⁶ In determining the use to which an asset may be put ‘all reasonably fair contingencies’ are to be considered.⁷ Those contingencies are limited to ones that a hypothetical prudent buyer would entertain.⁸ Further, such contingencies must not be purely academic; there must be a continuing demand for the particular contingency.⁹ It follows that where an asset could not have a value to anyone under any contingency, applying the hypothetical market construct does not result in a market value being found for the asset.

24. Market value is arrived at having regard to the highest and best use of the asset.¹⁰ The market value is not necessarily the highest price that any one hypothetical buyer would be willing to pay or at which any one hypothetical seller would be willing to sell. It is ‘the point at which the parties would meet’ by voluntary bargaining¹¹ in a notional sale. Unique special value to the actual seller will not be reflected in this value.¹²

25. When working out the value of a business, transactions that are not on an arm’s length basis need to be adjusted to an arm’s length basis even though they are made under a binding legal agreement unless it can be established that it would be commercially realistic for the entity to be sold with such an agreement in place. To demonstrate that it would be commercially realistic to dispose of an entity with such an agreement in place it would be necessary to obtain from the market examples of sales of a comparable entity with a comparable agreement in place. The effect of recognising such binding legal agreements is that the market value will reflect the benefit or burden that the agreement brings to the entity.

⁵ See, for example, *Brisbane Water County Council v. Commissioner of Stamp Duties* [1979] 1 NSWLR 320 at 324, where Waddell J states that ‘all possible purchasers are to be taken into account ...’. This is considered to impose a requirement to ‘consider the existence and identity of persons who, on an objective standard, could reasonably be expected to bid’: refer Marks B, ‘Valuation Principles in the Income Tax Assessment Act’, (1996) 8 Bond LR 114 at 131. Hypothetical sellers who could reasonably be interested in selling would consist of those who would be ‘prepared to sell, provided a fair price is obtained under all the circumstances of the case’ and would not extend to those who ‘would be prepared to sell at any price and on any terms’: *Inland Revenue Commissioners v. Clay* [1914] 3 KB 466 at 478, CA, per Pickford LJ.

⁶ See for example *Bopark Building (No. 8) Pty Ltd v. Minister for Lands* (1968) 70 SR (NSW) 366 at 344-345 where Sugerman JA remarked: ‘As to the nature and extent of the market everything is dependent upon such factors as ... the uses to which it [the land] may best be put ...’.

⁷ *Spencer v. The Commonwealth* (1907) 5 CLR 418 at 436.

⁸ *Spencer v. The Commonwealth* (1907) 5 CLR 418 at 440 to 441.

⁹ See *Collis v. Commissioner of Taxation (Cth)* (1996) 96 ATC 4831 at 4841. Jenkinson J favourably refers to *Hustlers Pty Ltd v. The Valuer-General* (1967) 14 LGRA 269, where (at 274-278) the learned judge said: ‘... it is essential to remember that although the special adaptability of land for a specific purpose is an element in value, it is essential to the existence of a market that there be some continuing demand for land for that purpose ... In other words, whatever suitability the subject lands might have for a retail store or stores cannot influence value unless one can point to a field of potential purchasers who would be prepared to acquire those lands for such a purpose.’

¹⁰ See, for example, *Spencer v. The Commonwealth* (1907) 5 CLR 418 at 440 to 441, where Griffith CJ remarked that the value of the land was to be established having regard to the ‘fair price ... which a hypothetical prudent purchaser would entertain, if he desired to purchase it for the most advantageous purpose for which it was adapted.’

¹¹ *Spencer v. The Commonwealth* (1907) 5 CLR 418 at 441.

¹² See, for example, *Boland v. Yates Property Corp Pty Ltd* (1999) 167 ALR 575 at 654, where Callinan J said: ‘The special value of land is its value to the owner over and above its market value. It arises in circumstances in which there is a conjunction of some special factor relating to the land and a capacity on the part of the owner exclusively or perhaps almost exclusively to exploit it’.

Appendix 2 – Your comments

26. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: The Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel. The Tax Office may use a sanitised version (names and identifying information removed) of the compendium in providing its responses to persons providing comments. Please advise if you do not want your comments included in a sanitised compendium.)

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 97/20; TR 1999/16; TR 2005/17

Subject references:

- consolidation
- consolidation - assets
- consolidation - market value
- goodwill
- non-arm's length dealings
- synergistic goodwill

Legislative references:

- ITAA 1997 Div 705
- ITAA 1997 705-10(4)
- ITAA 1997 705-35(1)
- ITAA 1997 705-35(3)
- IT(TP)A 701-5

Case references:

- Boland v. Yates Property Corp Pty Ltd (1999) 74 ALJR 209; (1999) 167 ALR 575; [2000] Aust Torts Reports 81-538; [1999] HCA 64
- Bopark Building (No. 8) Pty Ltd v. Minister for Lands [1968] 3 NSW 183; (1968) 70 SR (NSW) 336; (1968) 88 WN (Pt 2) (NSW) 286
- Brisbane Water County Council v. Commissioner of Stamp Duties (NSW) [1979]

AEGR 71,315; (1979) 80 ATC 4051; (1979) 9 ATR 576; [1979] 1 NSWLR 320

- Capricorn Diamonds Investments Pty Ltd v. Catto and Ors (2002) 5 VR 61; [2002] VSC 105

- Collis v. Commissioner of Taxation (Cth) (1996) 96 ATC 4831; (1996) 33 ATR 438

- Federal Commissioner of Taxation v. Murry (1998) 193 CLR 605; (1998) 98 ATC 4585; (1998) 39 ATR 129

- Granby Pty Ltd v. Federal Commissioner of Taxation (1995) 129 ALR 503; (1995) 95 ATC 4240; (1995) 30 ATR 400

- Hustlers Pty Ltd v. The Valuer-General (1967) 14 LGRA 269; [1967] 2 NSW 760

- Inland Revenue Commissioners v. Clay [1914] 3 KB 466

- Spencer v. Commonwealth (1907) 5 CLR 418; (1907) 14 ALR 253; (1907) 3 QCLR 173

Other references:

- Accounting Standard AASB 136 Impairment of Assets (July 2004)
- Australian Valuation Handbook, Thomson CPD Business Solutions <www.taxpoint.com.au>
- Consolidation Reference Manual (CRM) C4-1
- Loneragan, W 2003, The Valuation of Businesses, Shares and Other Equity (4th ed.), Allen and Unwin, NSW
- Marks B, 'Valuation Principles in the Income Tax Assessment Act', (1996) 8 Bond LR 114

ATO references

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