TD 2007/1 - 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?

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?

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This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*. A public ruling is an expression of the Commissioner's opinion about the way in which a relevant 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. If you rely on this ruling, we must apply the law to you in the way set out in the ruling (unless we are satisfied that the ruling is incorrect and disadvantages you, in which case we may apply the law in a way that is more favourable for you – provided we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

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 11 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. This Determination is given in relation to working out the market value of a business of an entity as a step in working out the market value of goodwill for the purposes of subsections 701-10(2), 705-35(1) and 705-35(3) of the *Income Tax Assessment Act 1997* (ITAA 1997).

3. The methods set out in Taxation Ruling TR 97/20 can be applied to establish arm's length outcomes for transactions.

4. Adjustments to transactions to establish arm's length outcomes should be made where transactions are not at arm's length and they are relevant to the valuation of a business of an entity.

5. Adjustments to establish an arm's length outcome would not be required for transactions carried out under binding legal agreements in circumstances where it can be established that 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

6. *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.*

7. *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 methods outlined in TR 97/20.*

Date of effect

8. This Ruling applies to years of income commencing both before and after its date of issue. However, the Ruling does 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 Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
28 February 2007

Appendix 1 – Explanation

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

Explanation

9. 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 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.

10. Goodwill of an entity is a reset cost base asset and its tax cost is set under subsections 701-10(2), 705-35(1) and 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.

(See Taxation Ruling TR 2005/17, paragraph 7.)

11. 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 (See Taxation Ruling TR 1999/16 at paragraphs 47 to 49).

12. 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.

13. 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.

14. Lonergan[1] 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.[2]

15. 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.

16. Obtaining a market valuation on an arm's length basis for the purposes of applying subsections 701-10(2), 705-35(1) and 705-35(3) of the ITAA 1997 usually 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.

17. 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:

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

18. Similar views are expressed in the Australian Valuation Handbook[3] at paragraph 8-1350:

> Some of the 'unusual transactions' that we have adjusted for in the past have included:
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> a. sales (where inter-business transfers have occurred at non-arm's length prices or where they may not occur in the future);
>
> b. other non-arm's length transactions at above or below market rates;

19. 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*.

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[1] Lonergan, W 2003, The Valuation of Businesses, Shares and Other Equity (4th ed.), Allen and Unwin, NSW.
[2] See also the ATO publication Consolidation Reference Manual for a definition arrived at in consultation with community and Australian Government business valuers, http://www.ato.gov.au/, C-4 at page 31.
[3] Thomson CPD Business Solutions: www.taxpoint.com.au.

20. 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:
>
> (i) the future cash inflows used to determine the asset's or cash-generating unit's value in use; and
>
> (ii) 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.

21. Applying valuation principles to arrive at the market value of a business of an entity for consolidation purposes requires the market value of each business of the entity to be 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.

22. If a business has engaged in intra-group 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. Adjustments can be made in accordance with the methodologies set out in TR 97/20.

23. 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.

24. Obtaining a market valuation on an arm's length basis for consolidation purposes requires a market for the asset to be hypothesized.[4] 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.[5]

[4] 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.
[5] 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 ...'.

25. 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.[6] A factor which influences the nature and extent of such a market is the use to which an asset may be put.[7] In determining the use to which an asset may be put 'all reasonably fair contingencies' are to be considered.[8] Those contingencies are limited to ones that a hypothetical prudent buyer would entertain.[9] Further, such contingencies must not be purely academic; there must be a continuing demand for the particular contingency.[10] 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.

26. Market value is arrived at having regard to the highest and best use of the asset.[11] 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 bargaining[12] in a notional sale. Unique special value to the actual seller will not be reflected in this value.[13]

27. 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. It may not be commercially realistic to assume that favourable or unfavourable agreements between related entities or other parties not dealing at arm's length would remain in place when one of the entities is sold. A method that could be used to show that it would be commercially realistic to dispose of an entity with such an agreement in place would be to demonstrate that sales of comparable entities with a comparable agreement in place have occurred in the market. There may also be other methods that include a market reference point that could be applied.

28. Ultimately the effect of recognising such a binding legal agreement is that the market value will reflect the benefit or burden that the agreement brings to the entity.

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[6] 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.

[7] 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 ...'.

[8] *Spencer v. The Commonwealth* (1907) 5 CLR 418 at 436.

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

[10] 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.'

[11] 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.'

[12] *Spencer v. The Commonwealth* (1907) 5 CLR 418 at 441.

[13] 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'.

References

Previous draft:

TD 2006/D43

Related Rulings/Determinations:

TR 97/20; TR 1999/16; TR 2005/17;
TR 2006/10

Subject references:

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

Legislative references:

- TAA 1953
- ITAA 1997 Div 705
- ITAA 1997 701-10(2)
- 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 NSWR 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 NSWR 760
- Inland Revenue Commissioners v. Clay [1914] 3 KB 466
- Spencer v. Commonwealth (1907) 5 CLR 418; (1907) 14 ALR 253; (1907) 3 QCLLR 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
- Lonergan, 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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