TD 2007/27 - Income tax: consolidation: is the cost base of the goodwill referred to in subsection 711-25(2) of the Income Tax Assessment Act 1997 limited to the cost base of goodwill previously identified under subsection 705-35(3) of that Act?

Taxation Determination

Income tax: consolidation: is the cost base of the goodwill referred to in subsection 711-25(2) of the *Income Tax Assessment Act 1997* limited to the cost base of goodwill previously identified under subsection 705-35(3) of that Act?

This Ruling provides you with the following level of protection:

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.

[**Note:** This is a consolidated version of this document. Refer to the ATO Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.]

Ruling

1. Yes. Subsections 705-35(3) and 711-25(2) of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] are complementary provisions with the effect that subsection 711-25(2) only refers to goodwill that was separately identified and its cost base or reduced cost base worked out and set under subsection 705-35(3).

2. Goodwill identified under subsection 705-35(3) (subsection 705-35(3) goodwill) can split from and merge with other goodwill in accordance with changes to the management, organisation and structure of the business to which it is connected. Whether such goodwill has split, merged or done neither, it retains its character as a separately identifiable CGT asset with a cost base or reduced cost base for the limited purposes of subsection 711-25(2) only.

[1] All subsequent legislative references are to the ITAA 1997 unless otherwise indicated.

3. In order to identify such goodwill, the records of the group should show as a minimum:

- the total amount of economic benefits expected to accrue to existing group members at the joining time from control and ownership of a joining entity and the basis on which that amount was determined;
- the entities and their respective businesses that gave rise to each amount of subsection 705-35(3) goodwill (a head company can have more than one goodwill asset);
- the market value of amounts of subsection 705-35(3) goodwill attributable to each business of the group just after the joining time and the basis on which the values were worked out or sufficient information to work out these values; and
- details of any split or merger of subsection 705-35(3) goodwill and of the changes to a business or businesses of the head company that subsequently affected that goodwill.[2]

Example 1

4. *H Co is the head company of a consolidated group. H Co carries on a manufacturing business. H Co purchases 100% of A Co which carries on business as a distributor. H Co's goodwill is existing goodwill from its manufacturing business and subsection 705-35(3) goodwill from its control and ownership of A Co. Similarly A Co has goodwill consisting of its own existing goodwill from its distribution business and may have synergistic goodwill from its relationship with the consolidated group.*

5. *H Co sells all of its shares in A Co and synergies between the businesses are destroyed. The value of H Co's goodwill in its business is reduced but not destroyed in this case.*

6. *Under subsection 711-25(2) the cost base or reduced cost base of the section 705-35(3) goodwill that the head company holds at the leaving time because of its control and ownership of A Co is added to the step 1 amount to work out the old group's tax cost setting amount for membership interests in the leaving entity, A Co.*

Example 2

7. *Assume the same facts as Example 1. The quantum of the tax cost setting amount worked out for subsection 705-35(3) goodwill (S1) when A Co joined the group was $100m.*

8. *H Co splits its manufacturing business into two separate businesses Manufacturing 1 and Manufacturing 2 .They each benefit equally from association with A*

[2] Ceasing to be a member of a consolidated group may cause a CGT event to happen. If a head company sells shares in an entity CGT event A1 (disposal of a CGT asset) may occur. Ceasing to be a member of a group may have revenue consequences if the sale of shares is on revenue account (for example, if the head company holds the membership interests for a profit making purpose). The head company will therefore need to keep records in accordance with section 262A of the *Income Tax Assessment Act 1936* and section 121-20 of the ITAA 1997.

Co's distribution business. H Co records the effect of the split (S2) on the subsection 705-35(3) goodwill as follows:

Manufacturing 1 – A Co Distribution S2 = $50m in Manufacturing 1

Manufacturing 2 – A Co Distribution S2 = $50m in Manufacturing 2

9. *H Co transfers Manufacturing 2 to C Co. Then C Co leaves the group.*

10. *In working out the amount of goodwill to be added at Step 1 under subsection 711-25(1), the amount of the cost base or reduced cost base of subsection 705-35(3) goodwill connected to Manufacturing 2, $50m, is simply included in the cost base or reduced cost base of any other goodwill that C Co has.*

11. *In considering the amount if any that can be added to the Step 1 amount under subsection 711-25(2) the recorded link between Manufacturing 2 and A Co Distribution is noted and it is considered that part of the goodwill of A Co Distribution could be lost with the loss of ownership and control of C Co containing Manufacturing 2. However, this goodwill did not get a separate tax cost setting amount under subsection 705-35(3) when A Co joined the group. There is therefore no amount to be added to the Step 1 amount under subsection 711-25(2).*

12. *If A Co subsequently left the group the cost base or reduced cost base of the subsection 705-35(3) goodwill attached to Manufacturing 1 could be added to A Co's Step 1 amount under subsection 711-25(2) if all the tests required by that provision are met.*

Date of effect

13. This Determination applies both before and after its date of issue. However, the Determination 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 Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
17 October 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

14. Subsection 705-35(3) recognises the goodwill that accrues to a business or businesses of the acquiring group as a separate asset when a subsidiary member joins a group. Refer to Taxation Ruling TR 2005/17 Income tax: goodwill: identification and tax cost setting for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*, paragraphs 11 to 15, where the effect of the provision is discussed in detail.

15. For practical purposes, the circumstances where subsection 705-35(3) goodwill would be capable of being attributed a value using a recognised market valuation methodology, and could therefore be identified as a separate commercial or business asset,[3] in the sense contemplated by subsection 705-35(1), would not be common.[4] Subsection 705-35(3) is essentially an integrity measure that is only invoked where it is argued that part of the economic value of the jointing entity is not represented by an asset of the joining entity but, rather, emerges as part of the goodwill of one or more of the businesses of the acquiring entity.

16. Division 711 addresses how to work out a consolidated group's cost of membership interests in entities that cease to be subsidiary members of a consolidated group. The tax cost setting amount for each membership interest that the old group holds in a leaving entity is worked out under sections 711-15 and 711-20. The first step in working out the tax cost setting amount for membership interests under subsection 711-25(1) (the step 1 amount) is to add up the terminating values of the leaving entity's assets. The terminating value of a CGT asset that a head company holds at the leaving time (other than trading stock, qualifying securities and depreciating assets) is equal to its cost base (section 711-30 and subsection 705-30(4)) or its reduced cost base where subsection 711-20(2) applies.

17. Subsection 711-25(2) provides that if loss of control and ownership of the leaving entity by the head company would decrease the market value of the goodwill of the old group, the head company's cost base of goodwill (that it holds at the leaving time because of its control and ownership of the leaving entity) is added to the step 1 amount. The note to subsection 711-25(2) connects the type of goodwill identified under this provision with the goodwill that is identified under subsection 705-35(3).

18. In the context of the consolidation cost setting rules on entry and exit, subsection 705-35(3) goodwill is separately identified by the specific provisions of subsections 705-35(3) and 711-25(2). On entry subsection 705-35(3) sets a separate cost base or reduced cost base for this separately identified goodwill. Subsection 711-25(2) does not specify a tax cost setting amount or a cost base or reduced cost base for this goodwill at the leaving time.

[3] See Taxation Ruling TR 2004/13 Income tax: the meaning of an asset for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*, especially paragraphs 3 to 6.
[4] Refer to Consolidation Reference Manual C2.1-070 pp 3-4 where detailed guidelines are provided on recognising synergistic goodwill.

19. The general CGT rules in Part 3-1 do not recognise subsection 705-35(3) goodwill as an asset separate from the goodwill asset of the business of the acquiring group. Nor do the general CGT rules provide a separate cost base or reduced cost base for such goodwill. As decided in *Federal Commissioner of Taxation v. Murry* (1998) 193 CLR 605, discussed in Taxation Ruling TR 2005/17, goodwill is a single indivisible asset that attaches to a business. Under the ordinary tax treatment of goodwill, the type of goodwill explicitly recognised under subsection 705-35(3) simply forms part of that broader goodwill asset attaching to a business.

20. Accordingly, the cost base or reduced cost base added under subsection 711-25(2) to the tax cost setting amount for membership interests that the old group holds in the leaving entity at the leaving time is the cost base or reduced cost base worked out under subsection 705-35(3) assuming some of this goodwill still exists. This is the only provision that sets a separate cost base or reduced cost base for the specific type of goodwill referred to in subsection 711-25(2). If no goodwill was recognised at the joining time under subsection 705-35(3) then at the leaving time no amount can be included in the cost base of the membership interests under subsection 711-25(2).

21. A further point to note is that where a consolidated group acquires a business directly the cost setting rules of Division 705, including subsection 705-35(3), do not apply. Only the goodwill of the acquired business has a cost base or reduced cost base as a result of the transaction under the general CGT rules in Part 3-1.

22. Businesses of an entity may split or merge over time and goodwill of these businesses may split or merge in accordance with the way the businesses are re-organised or restructured. The cost base of subsection 705-35(3) goodwill may therefore be split into two or more amounts or merge with other goodwill in accordance with business changes, as is the case with goodwill generally.[5] The subsection 705-35(3) goodwill continues to maintain its separate identity and separate cost base for the limited purposes of subsection 711-25(2) only.

23. To determine if subsection 711-25(2) applies when a particular entity leaves the consolidated group it is necessary to determine whether one or more businesses of that leaving entity gave rise to a subsection 705-35(3) goodwill asset in one or more of the remaining businesses of the head company at an earlier joining time. Such goodwill may have arisen from synergies between multiple businesses of a joining entity and multiple businesses of the consolidated group which were recognised as separate assets of the head company and deemed to be assets of the joining entity under subsection 705-35(3) at the joining time.

24. In order to identify the correct cost base or reduced cost base of goodwill under subsection 711-25(2) it will be necessary to identify and record links between the businesses of the group and the businesses of the joining entity that gave rise to the subsection 705-35(3) goodwill. Similarly, if a business splits into two or more discrete businesses of the group, splits and merges with another business of the group or merges with another business of the group, the resulting quantum of subsection 705-35(3) goodwill will need to be worked out and recorded along with an identifying link between the business it is attached to and each business of a joining entity that originally gave rise to it.

[5] Refer to Taxation Ruling TR 99/16 Income tax: capital gains: goodwill of a business, at paragraphs 63 to 65 and paragraphs 70 to 79, for a summation of goodwill merger and split rules respectively.

References

Previous draft:

TD 2005/D21

Related Rulings/Determinations:

TR 99/16; TR 2004/13; TR 2005/17; TR 2006/10

Subject references:

- accounting and record keeping
- accounting records
- allocable cost amount
- capital gains tax
- CGT records
- consolidation
- consolidation – assets consolidation
- consolidation – exiting
- cost of membership interests
- documentation & records
- goodwill
- leaving entity
- synergistic goodwill

Legislative references:

- TAA 1953
- ITAA 1936 262A
- ITAA 1997 Pt 3-1
- ITAA 1997 121-20
- ITAA 1997 Pt 3-90
- ITAA 1997 Div 705
- ITAA 1997 705-30(4)
- ITAA 1997 705-35(1)
- ITAA 1997 705-35(3)
- ITAA 1997 Div 711
- ITAA 1997 711-15
- ITAA 1997 711-20
- ITAA 1997 711-20(2)
- ITAA 1997 711-25(1)
- ITAA 1997 711-25(2)
- ITAA 1997 711-30

Case references:

- Federal Commissioner of Taxation v. Murry (1998) 193 CLR 605; 98 ATC 4585; (1998) 39 ATR 129; (1998) 72 ALJR 1065; (1998) 155 ALR 67; [1998] HCA 42

Other references:

- Consolidation Reference Manual C2.1-070 pp 3-4, http://ato.gov.au

ATO references

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