TD 2011/26 - Income tax: capital gains tax: if a share in a 'no goodwill' incorporated professional practice is disposed of for no consideration, will the Commissioner accept, for the purposes of calculating the market value of the share upon a possible application of subsection 116-30(1) of the Income Tax Assessment Act 1997 that the goodwill of the company can be taken to have no value?

Taxation Determination

Income tax: capital gains tax: if a share in a 'no goodwill' incorporated professional practice is disposed of for no consideration, will the Commissioner accept, for the purposes of calculating the market value of the share upon a possible application of subsection 116-30(1) of the *Income Tax Assessment Act 1997* that the goodwill of the company can be taken to have no value?

Ruling

1. Yes, the Commissioner will accept in calculating the market value of the share in applying subsection 116-30(1) of the *Income Tax Assessment Act 1997* (ITAA 1997),[1] that the goodwill of the company can be taken to have a value of nil.

2. This approach will apply only for dealings done at arm's length for admissions to, and exits from, the professional practice in the natural 'ebb and flow' of natural person practitioner-shareholders into and out of the company. For the approach to apply, all practitioner-shareholders must agree to follow the approach explained in this

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

Determination, and all must agree that the cost base calculation for the purchaser will be the reflex of the capital proceeds approach outlined in the Determination.

3. Where a 'no goodwill' professional partnership has incorporated or a new 'no goodwill' incorporated professional practice has commenced, the following features must be displayed by the incorporated professional practice (the company) in order that it qualifies as a 'no goodwill' company for the purposes of this Determination:

(a) The original shareholders in the company are all natural person practitioners who previously held a fractional interest in the 'no goodwill' partnership prior to the restructure (or would have been eligible to hold a fractional interest had the practice first operated as a partnership);

(b) The provision of a share or shares to the practitioner-shareholder at the time of incorporation and in the post-incorporated environment must be reflective of that person's status as an active practitioner in the practice and must be held by that person both legally and beneficially;

(c) The company is a proprietary limited company that adopts a constitution or shareholder agreement, or both, that regulates the basis

- for admission to shareholding, and
- buy-back, cancellation or transfer of shares in the company, and
- the amount that is paid for it, and
- all the shareholders agree to be bound by it; and

(d) The constitution or shareholder agreement, or both, provide that any share dealing effecting practitioner-shareholders joining or leaving the practice will be attended by an amount of consideration (including possibly nil consideration) calculated on the basis that the value of the goodwill of the company is nil.

4. That is, the Commissioner will accept, in a post incorporation context, an approach analogous to the approach already provided for in *Taxation Ruling IT 2540 Income tax: capital gains: application to disposals of partnership assets and partnership interests*. But it will be limited to dealings involving shares in incorporated professional practices which faithfully mirror the same proportional underlying economic ownership transactions and relationships which would have attracted the abovementioned approach in a partnership context.

Example

5. *Professional Practice Co Pty Ltd is an incorporated professional practice which does not require practitioner-shareholders to pay a price on admission to the firm that relates to the goodwill of the company, and does not pay any amount to practitioner-shareholders leaving the firm, that relates to the goodwill of the company. Although the practice does not recognise goodwill in dealings between practitioners on admission to and exit from the practice, the firm has goodwill with a value of $500,000. At the time of the relevant transactions, the firm's other assets have nil or negligible value. On 1 July 2011, two practitioner-shareholders retire and their shares are redeemed for nil consideration, consistent with the firm's status as a 'no-goodwill' incorporated professional practice. On the same day, a new practitioner-shareholder is admitted to the firm. The Commissioner will accept for the purposes of subsection 116-30(1) that the market value of the shares redeemed is nil (but only for the purposes of calculating the market value of the shares redeemed). The new practitioner-shareholder pays nothing for the shares in the company and his cost base for his shares is nil, mirroring the capital proceeds approach.*

Date of effect

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

Commissioner of Taxation
26 October 2011

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.

Professional practices

7. Professional partnerships are traditionally structured in one of two ways, either recognising goodwill or not recognising goodwill in determining whether practitioners have to pay to join the practice. In professional partnerships recognising goodwill, when a new partner is admitted they are usually required to pay a purchase price for the acquisition of an interest in the partnership goodwill. When the partner leaves the partnership and their interest is sold either to a newly admitted partner or to the remaining partners, the exiting partner would usually be entitled to receive a payment for their share of the partnership goodwill.

8. 'No goodwill' professional partnerships are often larger partnerships which can have memberships numbering in the hundreds. In these cases, the partners agree that when a new partner is admitted into the partnership they are not required to pay a purchase price for the acquisition of an interest in the partnership goodwill. When the partner leaves the partnership and their interest is sold either to a newly admitted partner or to the remaining partners, the exiting partner would not be entitled to receive a payment for their share of the partnership goodwill.

9. The Australian Taxation Office understands that restrictions have been removed in some professions and professional practitioners are able to incorporate and run their practice through a company. As a result, practitioners may choose to start up as an incorporated professional practice or replicate their 'no goodwill' professional partnership arrangements when restructuring into an incorporated professional practice.

10. By incorporating a professional partnership which replicates a 'no goodwill' professional partnership, a new shareholder in a 'no goodwill' incorporated professional practice would not be required to pay an amount for the shares that reflects merely any underlying goodwill in the company. Similarly, an outgoing shareholder would not be entitled to receive a payment for the shares reflecting the value of goodwill when those shares are transferred to another shareholder (or back to the company in a share buyback) or cancelled (either by a reduction in capital or following a share buyback).

Dealings of interests in professional practices

11. A 'no goodwill' professional practice can incorporate from a 'no goodwill' professional partnership or it can incorporate (as a new practice) as a start-up 'no goodwill' company. After incorporation dealings in the shares occur from the natural 'ebb and flow' of practitioner-shareholders into and out of the company. That is, the addition, retirement or expulsion of a practitioner-shareholder from the practice by way of issue, buyback, transfer or cancellation of shares in the company).

12. When a no-goodwill professional partnership restructures into a proprietary limited company, a taxing point will normally arise. Under Subdivision 122-B the former partners may choose rollover relief from possible taxation consequences (in prescribed conditions) where they maintain their proportional underlying economic ownership of the former partnership assets in the company by way of shares equivalent in value to the partnership interests they give up.

13. This Determination is one of three addressing the taxation implications of dealings in shares in incorporated 'no goodwill' professional practices from the natural 'ebb and flow' of natural person practitioner-shareholders into and out of the company, including the share buyback implications (TD 2011/D10) and employee share scheme implications from the issue of shares to employees (TD 2011/D9). This Determination does not cover issues associated with the incorporation itself or any other type of restructure of the practice.

Capital gains tax statutory background

14. In most cases dealings between practitioner-shareholders in professional practices in respect of the admission to or exit from the practice of practitioners will be at arm's length, and this Determination has application only in the context of this kind of dealing. Very broadly speaking, if a person's dealing in respect of his or her CGT asset is at arm's length, the actual proceeds received will constitute the capital proceeds for CGT purposes, irrespective of the market value of that asset (subparagraph 116-30(2)(b)(i) precludes market value substitution where the dealing is at arm's length). But there is a significant exception – market value substitution applies where there are **nil** proceeds received. In such a case the market value of the asset at the time of the dealing constitutes the capital proceeds for CGT purposes (subsection 116-30(1) invokes market value substitution).

IT 2540 approach

15. IT 2540 considers the operation of the capital gains provisions in relation to certain partner dealings in partnership interests. Relevantly, for the purposes of this Determination, IT 2540 addresses the disposal and acquisition of partnership interests in the context of 'no goodwill' partnerships.

16. Paragraph 13 of IT 2540 deals with cases where no consideration is received for the disposal of a partnership interest in a 'no goodwill' partnership. Where the evidence demonstrates that such dealings are at arm's length, the Commissioner will accept where there is no consideration that the market value of the partnership interest is nil.

17. IT 2540 was released in 1989 at a time when some professions were restricted by rules imposed by State legislation and their State regulatory bodies to practise either as a sole trader or a partnership of natural persons. As such, the approach provided in IT 2540 only applied to acquisitions and disposals of partnership interests by natural person practitioners. This aspect of IT 2540 is also limited to dealings that occur during the normal 'ebb and flow' of natural person partners into and out of a partnership, and does not apply to restructures or arrangements involving the disposal of the practice.

18. Specifically, the Commissioner expects that the following conditions must be satisfied for the application of IT 2540 to partners in professional partnerships:

(i) the partners in the partnership are all natural person practitioners who hold a fractional interest in the 'no goodwill' partnership;

(ii) the acquisition or disposal of an interest in the partnership must be reflective of that person's status as an active practitioner in the practice and held by that person both legally and beneficially; in this context 'active partner' will include managing partners who do not undertake client work and non-practitioner consultants (for example legal counsel in an accounting firm);

(iii) the partnership has capital which reflects merely a nil or immaterial value for goodwill, except in circumstances where the partnership has taken over another practice with goodwill, and such acquired goodwill remains on the partnership's books; in that circumstance, provided the partners cease to recognise that goodwill in dealings between themselves for the admission and exit of partners this condition will be satisfied;

(iv) the partnership adopts an agreement that regulates the basis for admission and exit of partners and the amount that is paid for it; and

(v) the partnership agreement provides that no or an immaterial payment is to be made for acquiring a partnership interest, disposing of a partnership interest or any change to the profit distribution entitlements attached to an interest in the partnership, in respect of goodwill.

Post-incorporation

19. Where a 'no goodwill' incorporated professional practice satisfies the conditions described in this Determination, the Commissioner's post-incorporation approach will apply so that the Commissioner will accept for the purpose of calculating the market value of the shares in applying subsection 116-30(1) that the goodwill of the company can be taken to have a market value of nil, irrespective of the actual value. Consistent with paragraph 13 in IT 2540 any consideration paid or received on the acquisition or disposal of a share or shares in an incorporated professional practice will generally be used for Part 3-1 purposes in determining the cost base or capital proceeds of those shares. This will mean that in the case of a 'no goodwill' incorporated professional practice where the approach described in paragraphs 2 to 4 of this Determination applies, the cost base and the capital proceeds will be nil where nothing is paid in respect of underlying goodwill, and any other assets of the company have a nil or negligible value.

20. It would not be expected that arrangements of a kind that would ordinarily be regarded as arm's length dealings in shares in a professional practice company would suffer any compromise to such arm's length status merely because the dealings were for suppressed consideration on account of the company being a bona fide 'no goodwill' professional practice company.

21. Where the incorporated professional practice and its shareholders do not satisfy the conditions described in paragraphs 2 to 3 of this Determination the Commissioner's post-incorporation approach cannot be applied. All shareholders of the incorporated professional practice will cease to benefit from this approach as a consequence when an entity other than a natural person practitioner acquires a share or shares in that company. The approach will not apply in respect of any dealings in the shares of that company for any period during which even one share is held, whether legally or beneficially, otherwise than in the way described.

References

Previous draft:

TD 2011/D3

Related Rulings/Determinations:

IT 2540, TR 2006/10

Subject references:

- capital gains
- CGT assets
- CGT capital proceeds modification market value substitution rule
- CGT cost base modification market value substitution rule
- CGT event A1 - disposal of a CGT asset
- dividend income

Legislative references:

- ITAA 1936
- ITAA 1936 6(1)
- ITAA 1997
- ITAA 1997 Pt 3-1
- ITAA 1997 116-30(1)
- ITAA 1997 116-30(2)(b)(i)
- ITAA 1997 Subdiv 122-B
- TAA 1953

ATO references

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