



***TD 2011/D3 - Income tax: capital gains tax: will the Commissioner accept that the shares in a 'no goodwill' incorporated professional practice have a market value of nil when considering the application of subsection 116-30(1) of the Income Tax Assessment Act 1997 to an admission or exit of a practitioner-shareholder from the practice for no consideration?***

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This document has been finalised by [TD 2011/26](#).

 There is a Compendium for this document: [TD 2011/26EC](#) .



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## Draft Taxation Determination

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Income tax: capital gains tax: will the Commissioner accept that the shares in a ‘no goodwill’ incorporated professional practice have a market value of nil when considering the application of subsection 116-30(1) of the *Income Tax Assessment Act 1997* to an admission or exit of a practitioner-shareholder from the practice for no consideration?

**❗ 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 following way. 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, where the conditions set out in paragraph 2 of this draft Determination are satisfied the Commissioner will accept when applying subsection 116-30(1) of the *Income Tax Assessment Act 1997* (ITAA 1997)<sup>1</sup> that the shares in a ‘no goodwill’ incorporated professional practice have a market value of nil.
2. Where a ‘no goodwill’ professional partnership has incorporated or a new ‘no goodwill’ incorporated practice has commenced the following conditions must be satisfied for this approach to be adopted by shareholders in a professional practice company:
  - (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 operated as a partnership);

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<sup>1</sup> All legislative references are to the ITAA 1997 unless otherwise indicated.

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- (b) The provision of a share or shares 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;
- (c) The company holds no other assets and has a paid up capital which reflects an immaterial value for goodwill and which is generally kept intact such that all of its distributions of income or profits will be dividends within the meaning of subsection 6(1) of the *Income Tax Assessment Act 1936*;
- (d) The company adopts a constitution or shareholder agreement or both that regulate the basis for admission to shareholding and surrender or transfer of shares in the company and the amount that is paid for it; and
- (e) The constitution or shareholder agreement or both provide that no or an immaterial payment is to be made for acquiring a share, disposing of a share or any change to the profit distribution entitlements attached to a share in the company.

3. The Commissioner will, in a post incorporation context, adopt an approach analogous to the administrative approach already provided for in Taxation Ruling IT 2540 Income tax: capital gains: application to disposals of partnership assets and partnership interests. This approach will be limited to arm's length dealings involving shares in professional practice companies in situations which faithfully mirror underlying economic transactions and relationships which would have attracted the above mentioned administrative approach in a partnership context.

4. This means that in qualifying cases, the Commissioner will accept that the market value of a share that is the subject of arm's length dealing, but for which no amount is received as capital proceeds or paid as cost base is nil. This administrative approach will continue to apply so long as all of the shareholders agree to apply it. However, the Commissioner will not accept the administrative approach for the circumstances addressed in paragraph 19 of this draft Determination.

## **Date of effect**

5. When the final Determination is issued, it is proposed to apply 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 (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

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**Commissioner of Taxation**

16 March 2011

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## **Appendix 1 – Explanation**

**①** *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**

#### ***Professional Practices***

6. Professional partnerships are traditionally structured in one of two ways. In many partnerships 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 or an interest in the partnership that is not covered by paragraph 108-5(2)(c).<sup>2</sup> 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 or their interest in the partnership that is not covered by paragraph 108-5(2)(c) that they dispose of.

7. In a ‘no goodwill’ partnership it is generally understood that the ownership of the assets used by the partnership, other than the goodwill, are vested in a service company or trust. ‘No goodwill’ partnerships are usually larger partnerships which can have memberships numbering in the hundreds. In these cases, it is understood that 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 or an interest in a partnership that is not covered by paragraph 108-5(2)(c). 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 or their interest in a partnership that is not covered by paragraph 108-5(2)(c) that they dispose of.

8. The ATO understands that professional practitioners are now able to incorporate and run their practice through a company. As a result, practitioners may choose to replicate their ‘no goodwill’ partnership arrangements when restructuring into a company or starting up as an incorporated practice.

9. In incorporating the professional partnership which replicates a ‘no goodwill’ partnership, the ATO understands that the practice’s assets would continue to be vested in a service company or trust. When this occurs we understand that a new shareholder in a ‘no goodwill’ company would not usually be required to pay a purchase price when they acquire a share or shares in the company, to the extent that the value relates to goodwill. Similarly, an outgoing shareholder would not be entitled to receive a payment for the value of goodwill reflected in the shares of the company 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).

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<sup>2</sup> See paragraph 108-5(2)(d).

## ***Dealings of interests in professional practices***

10. When a 'no goodwill' professional partnership decides to incorporate there are several dealings that occur concerning the practice's ownership interests. These include:

- The establishment of the company;
- The exchange of the partner's fractional interest in the 'no goodwill' partnership for shares in the 'no goodwill' company; and
- 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 transfer or cancellation of shares in the company).

11. A 'no goodwill' company may also be what is described as a 'no goodwill' start-up company. That is, a new company that is not the result of a restructure from a partnership practice. Dealings also occur in this situation in respect of the shares in the company.

These include:

- The setting up of the company; and
- The natural 'ebb and flow' of practitioner-shareholders into and out of the company.

12. This draft Determination concerns only the dealings of shares in companies during the natural 'ebb and flow' of natural person practitioner-shareholders into and out of the company.

## ***CGT statutory background***

13. It might be said that in the general case, 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 (sub paragraph 116-30(2)(b)(i) precludes market value substitution). However, such a 'rule' falls short of being of universal application because it does not apply to the situation where there are no 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, even if the dealing is at arm's length (subsection 116-30(1) invokes market value substitution).

## ***IT 2540 approach***

14. 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 draft Determination, IT 2540 addresses the disposal and acquisition of partnership interests in the context of 'no goodwill' partnerships.

15. 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 that the market value of the partnership interest is nil.

16. IT 2540 was released in 1989 at a time when professional practitioners were restricted by rules imposed by State legislation and their State regulatory bodies to practice 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.

17. 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;
- (iii) The partnership holds no other assets and has a paid up capital which reflects a nil or immaterial value for goodwill;
- (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.

#### ***Post incorporation administrative approach***

18. Where an incorporated professional practice satisfies the conditions described in paragraph 2 of this draft Determination, the post incorporation administrative approach will apply and the Commissioner will accept that shares in a 'no goodwill' company have a market value of nil irrespective of its actual value and will apply subsection 116-30(1). In accordance with paragraph 13 in IT 2540 any consideration paid or received on the acquisition or disposal of a share or shares in an incorporated practice will 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 practice where the administrative approach described in paragraph's 3 and 4 of this draft Determination apply, the cost base and the capital proceeds will be nil.

19. Where the professional practice company does not satisfy the conditions described in paragraph 4 of this draft Determination the post incorporation administrative approach cannot be applied. All shareholders of the professional practice company will cease to benefit from this administrative approach as a consequence when an entity other than a natural person practitioner acquires a share or shares in that company. The approach continues to be unavailable 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.

## Appendix 3 – Your comments

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20. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

21. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- (a) provide responses to persons providing comments; and
- (b) publish on the ATO website at [www.ato.gov.au](http://www.ato.gov.au)

Please advise if you do not want your comments included in the edited version of the compendium.

**Due date:** 15 April 2011  
**Contact officer:** Shelley McCann  
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Brisbane QLD 4001

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## References

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*Previous draft:*

Not previously issued as a draft

- CGT event A1 - disposal of a CGT asset
- dividend income

*Related Rulings/Determinations:*

IT 2540; TR 2006/10

*Legislative references:*

*Subject references:*

- capital gains
- CGT assets
- CGT capital proceeds modification market value substitution rule
- CGT cost base modification market value substitution rule

- ITAA 1936 6(1)
- ITAA 1997
- ITAA 1997 Pt 3-1
- ITAA 1997 108-5(2)(c)
- ITAA 1997 108-5(2)(d)
- ITAA 1997 112-20(1)
- ITAA 1997 116-30(1)
- ITAA 1997 116-30(2)(b)(i)

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ATO references

NO: 1-1ZV6F8I

ISSN: 1038-8982

ATOlaw topic: Income Tax ~~ Capital Gains Tax ~~ miscellaneous  
Income Tax ~~ Capital Gains Tax ~~ CGT event A1 - disposal of a CGT asset  
Income Tax ~~ Entity specific matters ~~ partnerships