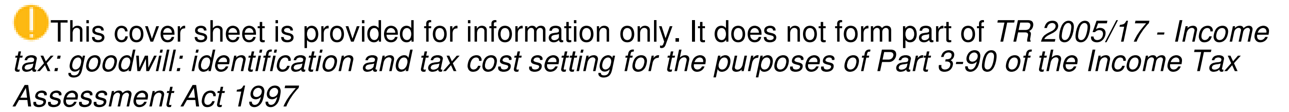
TR 2005/17 - Income tax: goodwill: identification and tax cost setting for the purposes of Part 3-90 of the Income Tax Assessment Act 1997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Taxation Ruling

Income tax: goodwill: identification and tax cost setting for the purposes of Part 3-90 of the *Income Tax Assessment Act 1997*

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Preamble

The number, subject heading, ***What this Ruling is about*** *(including* ***Class of person/arrangement*** *section),* ***Date of effect****, and* ***Ruling*** *parts of this document are a 'public ruling' for the purposes of* ***Part IVAAA of the Taxation Administration Act 1953*** *and are legally binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling explains how goodwill is identified and its tax cost setting amount calculated and set under the cost setting provisions of Part 3-90 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Date of effect

2. 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 21 and 22 of Taxation Ruling TR 92/20).

Ruling

Identifying goodwill for cost setting purposes

3. The cost setting provisions of Subdivision 705-A of the ITAA 1997 address both goodwill that is an asset of the joining entity and goodwill that is an asset of the acquiring group. Goodwill that is treated as an asset of the joining entity is discussed first in this ruling, followed by issues that arise in identifying goodwill generally. The treatment of goodwill that is treated as an asset of the acquiring group at the joining time is subsequently discussed. Because this latter goodwill is also treated as synergistic goodwill, there is an example provided in the Explanation to assist in identifying synergistic goodwill. Different treatments are required for each type of goodwill in the joining case, in the formation case and when an entity leaves a

group. These treatments are specifically dealt with in turn in this Ruling.

Goodwill as an asset of the joining entity

4. All assets of a joining entity that exist at the joining time are recognised as assets for the purpose of setting their cost under subsection 701-10(4) of the ITAA 1997. Goodwill is recognised as one of these assets. It is a reset cost base asset in accordance with subsection 705-35(1) of the ITAA 1997.

Determining the value of goodwill

5. Consistent with the view expressed by the High Court in *Murry v. Federal Commissioner of Taxation* 193 CLR 605; 98 ATC 4585; (1998) 39 ATR 129 (*Murry's case*) and followed in Taxation Ruling TR 1999/16, Income tax: capital gains: goodwill of a business, goodwill can be valued for the purposes of Part 3-90 of the ITAA 1997 using a residual value approach except in situations where the law has recognised that a residual value approach will not identify goodwill, as legally defined.

6. Two exceptions identified in *Murry's case* were where goodwill is being worked out for a non-profitable business or where a business had less than industry average profitability. The Court noted that in these situations, goodwill may be present even though an excess of the value of the business over the value of the net assets will not be revealed by the accounting residual value calculation. See *Murry* at 193 CLR at 624-625. For entities in these situations, the amount of goodwill, if any, will need to be determined by a direct examination of their particular circumstances.

The residual value approach in consolidation

7. The residual value approach to identifying and valuing goodwill when a subsidiary member joins a consolidated group entails working out 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.

In identifying assets and liabilities for the purpose of working out the value of the net identifiable assets of each business of the entity, both the commercial notion of assets and liabilities and the commercial basis of working out their value are used. This is because assets in consolidation cost setting are the assets that would be identified for commercial or business purposes in an acquisition. Refer to Taxation Ruling TR 2004/13 where the meaning of assets in consolidation cost setting is discussed in detail.

The entity's businesses

8. Each business of the entity is valued just before the joining time in accordance with accepted commercial or business valuation principles. Methods commonly used to value a business of an entity are based on the expected future net cash flows of the business. These methods include the discounted cash flow (DCF) method and the capitalisation of future maintainable profits (FMP) method.

Assets

9. The assets taken into account for the commercial residual value calculation are the commercial or business assets of the business. The identity of these assets may differ from assets identified in accounting reports and the values may also be different.

Liabilities

10. The liabilities of each business should also be identified and valued in accordance with commercial or business valuation principles. The liabilities recognised in the commercial residual value calculation may differ from the liabilities taken into account under subsection 705-70(1) of the ITAA 1997 for the purposes of working out the step 2 amount in the allocable cost amount (ACA) calculation because they are being recognised on a different basis. Their values, being solely at market value, may also be different.

Goodwill as an asset of the acquiring group

11. Subsection 705-35(3) of the ITAA 1997 addresses any synergistic goodwill that accretes to an acquiring group when an entity joins a consolidated group (subsection 705-35(3) goodwill). Such goodwill is deemed to be an asset of the joining entity by that provision. Thereafter it becomes part of the goodwill asset of each relevant business of the acquiring group for capital gains tax purposes within the terms of section 108-5 of the ITAA 1997. It is treated as part of the goodwill asset of a business and becomes an asset of the head company under the single entity rule for the head company core purposes referred to in section 701-1 of the ITAA 1997.

Joining case – subsection 705-35(3) goodwill

12. A tax cost setting amount is worked out for subsection 705-35(3) goodwill as if it is a separate asset of the joining entity by allocating some of the ACA to it in proportion to its market value. The market value of subsection 705-35(3) goodwill is a component of the market value of the total goodwill of a business of the joining entity worked out at the joining time using the commercial residual value approach. The tax cost setting amount becomes the cost base or reduced cost base of the subsection 705-35(3) goodwill under subsection 701-55(5) of the ITAA 1997.

13. One method of working out the amount of synergistic goodwill that accretes to the businesses of the acquiring group is to first work out the cash flow benefit that the acquisition of the joining entity brings to each such business. In working out the amount that is attributable to this goodwill as part of the value of the joining entity (its value for cost setting purposes) it would be reasonable, in the absence of any objective information to the contrary, to attribute a value to it of half the estimated amount of the total cash flow benefit attributable to synergies that the joining entity brings to each business of the acquiring entity.

Formation case – subsection 705-35(3) goodwill

14. Noting that it is not necessary to work out a value for the assets, including goodwill, of a chosen transitional entity because of the effect of section 701-15 of the *Income Tax (Transitional Provisions) Act 1997*, goodwill associated with each entity that is not a chosen transitional entity can be worked out using the commercial residual value method (as with the joining case). However, subsection 705-35(3) of the ITAA 1997 has no application to an entity when it forms part of a consolidated group where the residual value method of identifying goodwill is used and the businesses of the entity are valued using a valuation method based on the cash flow of each business. All the goodwill underlying the value of subsidiary members who are non-chosen transitional entities is effectively identified in the commercial residual value calculations carried out for non-chosen transitional entities.

15. It follows, therefore, that in respect of businesses in existence at the time of formation there will be no application of subsection 711-25(2) of the ITAA 1997 when a member of a forming group leaves as there will have been no cost base set for any goodwill associated with a business of the old group that has a relevant connection with the leaving entity.

Leaving case

16. The assets of a leaving entity that exist at the leaving time are used to derive the head company's tax cost of membership interests in the leaving entity that is set just before the leaving time under subsection 701-15(3) of the ITAA 1997. Goodwill that is one of the assets of the leaving entity is recognised at the leaving time for this purpose under subsection 711-25(1) of the ITAA 1997.

Leaving case – assets of the leaving entity

17. Subsection 711-25(1) of the ITAA 1997 provides that the Step 1 amount in working out the ACA of the membership interests of the leaving entity is the sum of the terminating values of all the assets that the head company holds at the leaving time. While in the group the leaving entity (with its assets) is taken to be part of the head company because of the single entity rule. The goodwill of the leaving entity identified under subsection 711-25(1) includes:

(i) inherent goodwill attached to the business of the leaving entity; and

(ii) synergistic goodwill that has accreted to a business of the leaving entity because of its association with the old group's business.

Leaving case – synergistic goodwill and subsection 711-25(2)

18. In addition to the cost of the goodwill of the leaving entity that is added to the ACA under subsection 711-25(1), subsection 711-25(2) adds an amount of the cost base of goodwill associated with businesses of the old group if it meets the following tests:

(a) the loss of control and ownership of the leaving entity by the head company, if it did occur, would reduce the market value of the goodwill associated with the businesses and assets of the old group, that is, other than those of the leaving entity;

(b) some or all of the goodwill asset associated with the businesses and assets that the old group holds at the leaving time exists because of its ownership and control of the leaving entity; and

(c) a tax cost was set for this goodwill at the joining time that would be its cost base at that time.

19. It is not usually necessary to carry out a market valuation of the goodwill referred to in relation to the first test. The test merely identifies the part of goodwill being referred to and is met when that part of goodwill is present that will reduce in value wherever there has been a loss of control or ownership of the leaving entity. It can be assumed that goodwill that arises from synergy between one or more businesses of the leaving entity will decrease in value with the loss of economic ownership or control of that entity. This is provided that contractual or other arrangements that will maintain the value of this goodwill after the entity leaves have not been entered into.

20. Where the tests are met, the cost base of this part of goodwill of a business or businesses of the old group is added to the costs that have been included in the ACA under subsection 711-25(1).

Explanation

Identifying goodwill for asset cost setting purposes

21. For consolidation cost setting purposes, all the assets of a joining entity are subject to the cost setting provisions of Division 705 of the ITAA 1997 unless the joining entity is a chosen transitional entity. The internally generated assets that are commercial or business assets of the acquired entity are included in the assets that are recognised and have a tax cost set.

22. The basis of identifying assets for consolidation cost setting is discussed in Taxation Ruling TR 2004/13 which deals with the meaning of an asset for the purposes of Part 3-90 of the ITAA 1997. For cost setting purposes, all the goodwill in a joining entity is identified and valued when the entity joins a group or forms part of a group unless the entity is a chosen transitional entity. An entity that is part of a forming group is treated as if it is being acquired. The head company's cost of acquiring a joining entity is treated as the head company's cost of acquiring all of the assets of the joining entity. Retained cost base assets and reset cost base assets have a tax cost set. The term 'reset cost base asset' is defined in subsection 705-35(1) of the ITAA 1997 as an asset that is not a retained cost base asset or an excluded asset covered by subsection 705-35(2) of the ITAA 1997. Goodwill of the joining entity is a reset cost base asset that has a tax cost set when the entity joins a consolidated group.

23. In some circumstances synergistic goodwill can accrete to an acquiring group and also add value to the joining entity. Subsection 705-35(3) provides for specific treatment to be given to such goodwill.

Legal versus accounting treatment of goodwill

24. The High Court in *Murry's case* reinforced the distinction between the legal and accounting notion of goodwill. However, the conventional accounting residual value method for identifying goodwill was supported as a valid method for identifying and determining the value of goodwill in most cases. Their Honours said (at 193 CLR 624):

> When a business is profitable and expected to continue to be profitable, its value may be measured by adopting the conventional accounting approach of finding the difference between the present value of the predicted earnings of the business and the fair value of its identifiable net assets.

This is commonly referred to as the residual value approach to working out goodwill. It is followed in Taxation Ruling TR 1999/16. The Court also noted that other methods may be applicable for valuing and identifying goodwill in a business trading at a loss or with less than industry-average profitability.

The residual value approach

25. The comments in *Murry's case* provide support for the view that the value of a joining entity's goodwill can be measured through the conventional accounting approach of finding the difference between the market value of each business of the joining entity and the value of the net identifiable assets of each of those businesses of the joining entity. The market value of all of the goodwill of the joining entity can be determined by summing the value of the goodwill found for each business of the entity. The residual value approach applies when a business is profitable and expected to continue to be profitable. In making the distinction between the legal and accounting method of working out an amount of goodwill, the Court commented (at 193 CLR 624) that:

> [The conventional accounting]… approach can cause problems in valuing goodwill for legal purposes because the identifiable assets need to be valued with precision. Particular assets, as shown in the books of the business, may be under or over valued and may require valuations of a number of assets and liabilities which may be difficult to value.

26. In a joining entity with a business trading at a loss or trading at less than industry average profitability, there may be a difference between the value of goodwill for legal purposes and its value for accounting or commercial purposes. The appropriateness of the residual value method for calculating such goodwill will need to be assessed on a case-by-case basis in light of the decision in *Murry's case*. This may occur where a business of an entity generates a positive cash flow but, for example, the business is encumbered by non-performing assets that nevertheless have substantial value. Whether goodwill is present in such cases, and what the value of its benefit to the business is, will need to be determined by a direct assessment of its contribution to earnings.

27. Questions that arise in applying the residual value approach in working out an amount of goodwill in the consolidation context include the basis of:

- working out the market value of each business of the entity; and
- identifying and determining a value for both assets and liabilities in working out the net identifiable asset value for each business.

Working out legal goodwill using the residual value calculation involves identifying the commercial value of each business of an entity and its assets and liabilities. The resulting calculation can conveniently be referred to as the 'commercial residual value calculation'. Some considerations in valuing the businesses of the entity and their assets and liabilities for the commercial residual value calculation are discussed below.

Valuing the businesses

28. The market value of each of the businesses of the entity is found using accepted business valuation methods and will include consideration of the non-current assets employed in the business together with any working capital items (such as inventories, receivables and employee provisions). Although various methods can be used to find a market value for a business in these circumstances, two commonly used methods are based on the cash flow of a business. These are (i) the discounted cash flow (DCF) method and (ii) the capitalisation of future maintainable profits (FMP) method.

(i) The DCF method involves the estimation of future cash flows of a business entity. The predicted cash flows are discounted to a present value using an appropriate discount rate. The discount rate is selected in light of various factors influencing value.

(ii) The FMP method requires the estimation of a maintainable profit amount in the current period and, using objective data such as the price earnings ratio of comparable entities trading on the stock exchange, working out a suitable market capitalisation rate for the business. The capitalisation rate is adjusted for factors such as future risks to earnings. The estimated net profits are multiplied by the capitalisation rate to determine the value of the business. Refer, for example*, Lonergan, W; The Valuation of Businesses Shares and Other Equity,* 2003, 4th ed., Chapters 2 and 3.

Identifying and valuing assets in working out goodwill

29. The High Court in *Murry's case* clearly distinguished between the values that would be carried for both assets and liabilities in the books of account and their commercial values. It is the commercial values of the assets and liabilities that are relevant to working out the value of goodwill under the residual value approach. Both assets and liabilities need to be measured for this purpose precisely rather than using an accounting book value. Assets are identified for consolidation cost setting under Divisions 701 and 705 of the ITAA 1997 on a commercial or business basis. Consequently, the assets identified for the commercial residual value calculation should be the same assets identified for the purpose of working out their tax cost setting amount.

30. Assets are valued at market value for the purpose of allocating cost under subsection 705-35(1). These market values are considered to be the appropriate values to be used in working out the amount of goodwill. A market value will need to be worked out for the retained cost base assets and excluded assets of the business in order to work out the value of goodwill. However, as an alternative, the value of losses and excluded assets of a business can be excluded from the market value of the joining entity rather than added to the value of the assets for the purpose of the commercial residual value calculation. The outcome is the same arithmetically.

31. Generally, if an asset is not identified and valued for inclusion in the residual value calculation the value of goodwill will increase by the value of the missing asset. Assets that would be regarded as commercial or business assets of the joining entity can be given a nil value, a substituted value or some other specific treatment under consolidation cost setting provisions. Such assets should be included in the goodwill calculation at their market value where they are commercial or business assets of the joining entity. A failure to identify and value such assets of the business would result in their value being inappropriately included in the market value of goodwill, skewing the allocation of ACA over reset cost base assets.

32. The assets identified and valued for the commercial residual value calculation can differ from the assets identified and valued for accounting purposes.

Identifying and valuing liabilities in working out goodwill

33. The liabilities of the business should be identified and valued on a commercial or business basis and may include, for example, contingent liabilities valued on the basis of the probability of the liability arising, which may not have been taken into account under subsection 705-70(1) of the ITAA 1997 in working out the amount of liabilities in the ACA calculation. It follows that liabilities identified for the goodwill calculation may differ from the accounting liabilities taken into account under subsection 705-70(1) and are not subject to the adjustments in Subdivision 705-A that apply to accounting liabilities identified for the ACA calculation.

Goodwill as an asset of the joining entity

34. The goodwill attaching to a business of a joining entity at the joining time will include:

1. inherent goodwill attached to the business of the joining entity; and
2. any synergistic goodwill accreting to the business of the joining entity because of its association with the acquiring entity's business or businesses.

This goodwill is identified and dealt with under subsection 705-35(1).

Goodwill as an asset of the acquiring group

35. In economic terms, not all of the goodwill represented in the purchase cost of the membership interests of an entity is an asset of the joining entity in accordance with subsection 705-35(1) of the ITAA 1997. When two businesses or entities combine under single economic control, and the combined value of the entities or businesses is greater when they are together, the businesses are said to generate synergistic benefits. These economic benefits are referred to as synergistic goodwill. A portion of the economic value of any synergistic goodwill that arises when a joining entity is acquired by a group can accrete to the acquiring group and exist as an asset or as an addition to an existing goodwill asset at the joining time. If the synergistic goodwill asset is present in the acquiring group at the joining time as a result of interaction with businesses of the joining entity, subsection 705-35(3) will apply.

36. The Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 states at paragraph 5.34 that:

> Any synergistic goodwill accruing to assets or businesses of a group, other than assets and businesses brought into the group by the joining entity, as a consequence of the group's ownership and control of the joining entity will be treated as a reset cost base asset of the joining entity.

37. The effect of subsection 705-35(3) of the ITAA 1997 is to deem subsection 705-35(3) goodwill to be an asset of the joining entity for the purpose of setting the cost of that entity's assets to the extent that it is reflected in the value of the joining entity. It is added to the assets of the joining entity for cost setting purposes. Paragraph 705-35(3)(a) sets its cost at its tax cost setting amount.

38. Subsection 705-35(3) goodwill is goodwill for CGT purposes within the terms of section 108-5 of the ITAA 1997. The Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 states further, at paragraph 5.34, that:

> As for other reset cost base assets, this synergistic goodwill has an amount determined as its cost to the head company. This amount will determine the cost base of this goodwill for CGT purposes.

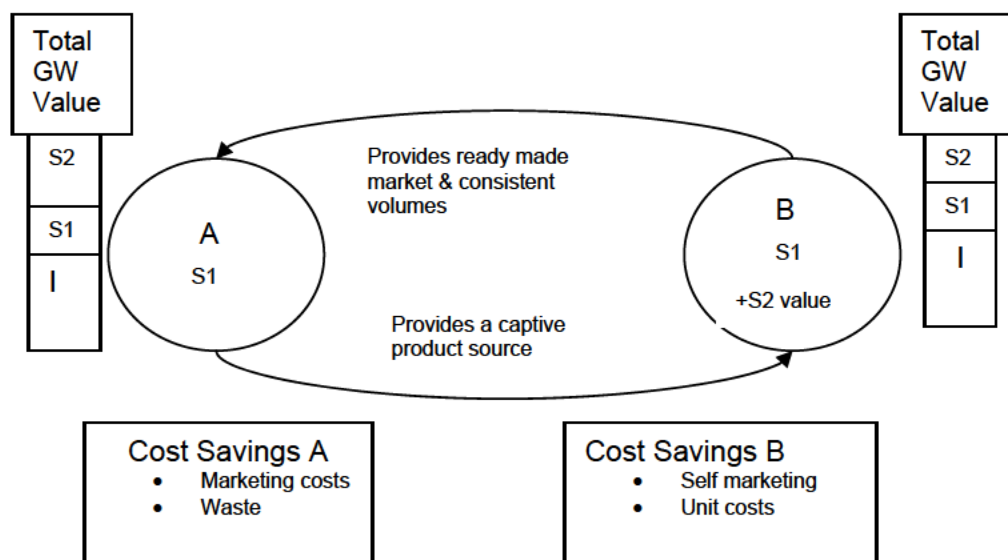
39. Subsection 701-55(5) of the ITAA 1997, which ensures that the tax cost set for a CGT asset at the tax cost setting amount becomes the cost base or reduced cost base of CGT assets, has the effect that the tax cost setting amount of the subsection 705-35(3) goodwill becomes its cost base or reduced cost base.

Synergistic Goodwill

40. The Australian Accounting Standards Board AASB 1013: Accounting for Goodwill, applicable up to 31 December 2005, describes at paragraph 5.1.1 goodwill arising from an entity acquisition as a payment made by an acquirer in anticipation of 'future economic benefits'. The future economic benefits may result from a synergy between businesses or assets of the acquired entity and acquirer. In *Hepples v. Federal Commissioner of Taxation* (1991) 173 CLR 492 at 542; 22 ATR 465 at 498; 91 ATC 4808 at 4837, McHugh J said:

> It will be seen from the statements in Inland Revenue Commissioners v. Muller & Co's Margarine Ltd [1901] AC 217 that goodwill is the collective name for various intangible sources of the earnings of a business which are not able to be individually quantified and recorded in the accounts as assets of the business. The goodwill may be constituted by sources internally generated by the business entity or from the combination or inter-relationship of entities or groups of assets (synergistic benefits) or both.

41. A set of circumstances where there can be synergistic goodwill of the joining entity and the acquiring entity is demonstrated in the following example:



42. A is a manufacturer. B is a distributor. A acquires B and allows an amount in the purchase price for B's inherent goodwill and the synergistic benefits it expects to obtain when B's business comes under its control. The value of such synergistic benefits is picked up in the residual goodwill calculation because they represent part of the value of the business of the acquired entity but cannot be classified as any other sort of asset.

43. In the example, additional profits are expected to be generated in B by the positive cash flow effect A's business has on B's business. This is labelled S1 type synergistic goodwill for B and is additional to the inherent goodwill B (I) already has. However A's business could also get a cash flow uplift because of the association with B. This is labelled S2 value in B which is also in addition to the inherent goodwill (I) it already has. A could pay for some or all of these potential synergistic benefits in its acquisition price. In value terms, this is reflected in an S2 amount in B's value even though there will never be such value in B, evidenced by an identifiable net cash flow. The same reasoning could be applied to A's value if B acquires A.

44. For the purposes of Part 3-90 of the ITAA 1997, the value of an entity will include a value for the expected synergistic benefits from combining the assets and businesses of the acquiring entity and the acquired entity. Calculating the goodwill of each business of the joining entity in accordance with the commercial residual value approach endorsed in *Murry's case*, will capture any goodwill that reflects the additional value the joining entity brings to the business or businesses of the acquiring group. Some of this goodwill may not be an asset of the joining entity.

Joining case – subsection 70-35(3) goodwill

45. Subsection 705-35(3) of the ITAA 1997 will apply if, just after the joining time, the head company has a goodwill asset associated with assets or businesses of the joined group because of its ownership and control of the joining entity.

46. The synergistic benefits that accrete to the head company because of its ownership and control of the joining entity must be identifiable as an asset at the joining time. Immediate benefits may not have emerged at the joining time, but the benefits should be reasonably prospective to the extent that they would be regarded commercially as having recognisable economic value. This is consistent with the Commissioner's view of the meaning of an 'asset of the joining entity' for the purposes of cost setting outlined in Taxation Ruling TR 2004/13. The Ruling states, essentially, that such assets are anything recognised in commerce and business as having economic value to the joining entity that is brought into a consolidated group. Similarly, the subsection 705-35(3) goodwill is an asset of the head company if there is a reasonable prospect at the joining time that the economic benefits will flow to the head company. If such an asset of the head company exists at the joining time it is deemed to be an asset of the joining entity by subparagraph 705-35(3)(b)(i).

47. The tax cost setting amount for the subsection 705-35(3) goodwill is worked out by allocating part of the joining entity's available ACA in proportion to its market value as with other reset cost based assets. The market value of this synergistic goodwill is a portion of the market value of the whole of the goodwill for each business of the joining entity calculated at the joining time. The market value of the whole of the goodwill underlying the market value of each business of the joining entity is ascertained using the residual value approach. Subparagraph 705-35(3)(b)(ii) states that if a goodwill asset associated with businesses or assets of the joined group has a tax cost setting amount set at the joining time, 'it is taken to have a market value just before the joining time of an amount equal to its market value just after the joining time'. The market value of the goodwill addressed by subsection 705-35(3) is reflected in the acquisition cost or market value of the entity even though it does not add to the value of assets of the joining entity.

48. Statutory market valuations are carried out in a hypothetical market, that is, one that assumes interested and informed but not anxious buyers are competing for an asset. It could reasonably be taken that the buyer and seller will be aware of the expected cash flow benefit to a business or businesses of the acquiring entity. In negotiating a price for the entity in light of this expected benefit it could also be reasonably taken in these circumstances that, as a result of the negotiation process, absent any objective information to the contrary, the value of the joining entity will reflect half the value of the known synergistic cash flow benefit to the acquirer. Consequently, this would be a reasonable basis for working out the value of the goodwill to be added to the assets of the joining entity by subsection 705-35(3). However, ultimately such considerations are a matter of fact and judgment in the absence of a clear provision in the legislation for working out the value. It is therefore open to arrive at a different conclusion if supported by objectively determined facts and a methodology reflecting accepted commercial practice.

49. The Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 states at paragraph 5.35 that:

> The market value of an entity can reflect its potential to add to the market value of the existing assets of potential acquirers. Therefore, the market value of the whole of this goodwill can be taken as the amount of any excess of the market value of the joining entity at the joining time over the market value of the net identifiable assets of the joining entity at that time.

50. The market value of the goodwill addressed by subsection 705-35(3) is a portion of the market value of the goodwill calculated for a joining entity that represents value added to the businesses and assets of the acquiring group.

51. Subsection 705-35(3) goodwill is goodwill for the purposes of the definition in section 108-5 of the ITAA 1997. Subsection 701-55(5) of the ITAA 1997 provides, broadly, that the tax cost setting amount becomes the cost base or reduced cost base of CGT assets. This goodwill is treated as a goodwill asset of the joining entity that becomes an asset of the head company because of the single entity rule in subsection 701-1(1) of the ITAA 1997. It is deemed to be an asset of the joining entity solely for the purpose of recognising the head company's cost of becoming the holder of the joining entity's assets as an amount reflecting the group's cost of acquiring the entity in subsection 701-10(2) of the ITAA 1997. For the purposes of any other income tax laws that address this goodwill asset, it is taken to add to an existing goodwill asset. If no existing goodwill is present it will constitute the whole of the goodwill asset that attaches to the relevant business of the acquiring group in which it arose.

Formation case – subsection 705-35(3) goodwill

52. Subsection 705-35(3) of the ITAA 1997 does not apply to a subsidiary member on formation of a consolidated group if the residual value method is used to identify and value goodwill and valuation methods based on cash flow have been used to value each business of the entity. Where valuation methods based on cash flow are used, adding an additional amount of goodwill representing a cash flow of a business of another entity in the group would duplicate the value of that goodwill where that other business would also be valued and have its goodwill calculated. This would amount to duplication of part of the goodwill assets of the forming group and would be inconsistent with the objects of Division 701 of the ITAA 1997 at section 701-10 and of Subdivision 705-A of the ITAA 1997 at subsection 705-10(3). The application of subsection 705-35(3) is therefore limited to the joining case if a valuation method based on cash flow is used to value the business of the entity. All the goodwill underlying the value of the subsidiary members whose costs are being set in a forming group is reflected in the values found for them where a valuation method based on cash flow is used in valuing the business of the entity. It is not necessary to separately identify goodwill under subsection 705-35(3) in these circumstances.

53. The example at paragraph 41 can be used to demonstrate the duplication of goodwill that could occur in a forming group. When a business of A in that example is being valued to apply the residual value calculation, all the value of A's business is determined using projections based on its cash flow. If there is synergistic goodwill present in B as a result of its association with A this would be within subsection 705-35(3) and treated as an asset of A under that subsection. However, when each of B's businesses is valued to work out its goodwill the same value that would be attributed to A by the effect of subsection 705-35(3) would be caught again in B's goodwill calculation. It is not necessary therefore to identify subsection 705-35(3) goodwill to capture all the goodwill of the entities whose goodwill is being valued by cash flow methodologies in the formation case.

54. Because subsection 705-35(3) goodwill is not found at formation time, there will be no goodwill that meets the tests of subsection 711-25(2) of the ITAA 1997 at the leaving time connected with businesses of the group that existed at the formation time ,as no cost base will have been set for it.

Goodwill treatment when an entity leaves a group

55. For consolidation asset tax cost setting purposes, the basis on which the tax cost setting amount for membership interests is established when an entity ceases to be a subsidiary member of a consolidated group is set out in the core rules in Division 701 of the ITAA 1997 and the specific asset cost setting rules in Division 711 of the ITAA 1997. Subsections 701-15(2) and (3) of the ITAA 1997 provide:

> *Object*
>
> (2) The object of this section is to preserve the alignment of the head company's cost for *membership interests in each entity and its assets by recognising, when an entity ceases to be a *subsidiary member of the group, the cost of those interests as an amount equal to the cost of the entity's assets at that time reduced by the amount of its liabilities.
>
> *Setting tax cost of membership interests*
>
> (3) For each *membership interest that the *head company of the group holds in an entity that ceases to be a subsidiary member, the interest's *tax cost is set just before the entity ceases to be a subsidiary member at the interest's tax cost setting amount.

The leaving case – goodwill assets of the leaving entity

56. The first step in calculating the ACA for the head company's membership interests in the leaving entity involves adding the terminating values of assets that the leaving entity takes with it when it ceases to be a subsidiary member. The amount is worked out in accordance with subsection 711-25(1) of the ITAA 1997.

57. The goodwill that falls within assets identified by 711-25(1) of the ITAA 1997 is an asset that the head company holds at the leaving time because the leaving entity is taken to be part of the head company. The point in time for identifying the assets and determining a terminating value for them is taken to be just before the leaving time. Goodwill attached to a business of the leaving entity at the leaving time may include the following:

- (i) inherent goodwill attached to the business of the leaving entity; and
- (ii) synergistic goodwill that has accreted to *a business of the leaving entity* because of its association with the old group's business.

The leaving case – subsection 711-25(2) goodwill

58. Subsection 711-25(2) of the ITAA 1997 provides that:

> If loss of control and ownership of the leaving entity by the *head company would decrease the *market value of the goodwill associated with assets or businesses of the old group (other than those of the leaving entity), the head company's *cost base of the asset consisting 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.

59. The Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002 states at paragraph 5.141 that:

> For the purposes of working out the cost of membership interest in the leaving entity, goodwill will be an asset of a leaving entity where it can be demonstrated that goodwill is leaving the group or is lost to the group as a result of the leaving entity ceasing to be a member of the group. This could occur, for example, because the goodwill is linked to assets of the leaving entity, or because of the entity leaving, some synergy is lost to the group.

60. Subsection 711-25(2) of the ITAA 1997 will apply to synergistic goodwill that has been separately recognised under subsection 705-35(3) of the ITAA 1997 and has a tax cost set ('subsection 711-25(2) goodwill'). This goodwill arises in the business of an acquiring group when a joining entity becomes a member of the group. The cost allocated to subsection 711-25(2) goodwill under subsection 705-35(3), that becomes its cost base or reduced cost base because of subsection 701-55(5) of the ITAA 1997, will be added to the ACA worked out at step 1.

61. Each of the following tests must therefore be satisfied before subsection 711-25(2) goodwill is added to the step 1 amount:

(i) Would loss of control and ownership of the leaving entity by the head company, if it did occur, decrease the market value of the goodwill associated with businesses and assets of the old group (other than those of the leaving entity)?

(ii) Does some or all of the goodwill asset associated with the businesses or assets of the old group that the head company holds at the leaving time exist because of its ownership and control of the leaving entity? and

(iii) Has a cost been set for this goodwill at the joining time that would be its cost base at that time?

62. Where all of the tests described above are satisfied the whole of the cost base of such goodwill that has been worked out under subsection 705-35(3) is added to the ACA under step 1 of section 711-20 of the ITAA 1997, assuming no change to this goodwill of the business through split or merger. A market valuation of the group is not required to determine whether there is a 'decrease in the market value of the goodwill associated with the businesses of the old group'. This is determinable from an analysis of the relationship between the businesses of the leaving entity and the businesses of the old group. That is to say, the loss of common control of the relevant businesses can be taken to cause a loss of synergy unless contractual or other arrangements have been entered into that would maintain the synergy. It is the presence or absence of economic control or ownership that determines whether the synergy is maintained or lost.

Detailed contents list

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Commissioner of Taxation
7 September 2005

Previous draft:

TR 2004/D21

Related Rulings/Determinations:

TR 92/1; TR 92/20; TR 97/16;
TR 1999/16; TR 2004/13

Subject references:

- acquired entity
- acquiring group
- allocable cost amount
- asset
- business
- businesses
- capital gains tax
- cash flow
- consolidated group
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- control
- cost base
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- retained cost base asset
- subsidiary
- subsidiary member
- synergistic benefits
- synergistic goodwill
- synergy
- tax cost
- tax cost setting amount
- terminating value

Legislative references:

- ITAA 1997 108-5
- ITAA 1997 Pt 3-90
- ITAA 1997 Div 701
- ITAA 1997 701-1
- ITAA 1997 701-1(1)
- ITAA 1997 701-10
- ITAA 1997 701-10(2)
- ITAA 1997 701-10(4)
- ITAA 1997 701-15(2)

- ITAA 1997 701-15(3)
- ITAA 1997 701-55(5)
- ITAA 1997 Div 705
- ITAA 1997 Subdiv 705-A
- ITAA 1997 705-10(3)
- ITAA 1997 705-35(1)
- ITAA 1997 705-35(2)
- ITAA 1997 705-35(3)
- ITAA 1997 705-35(3)(a)
- ITAA 1997 705-35(3)(b)(i)
- ITAA 1997 705-35(3)(b)(ii)
- ITAA 1997 705-55(5)
- ITAA 1997 705-70(1)
- ITAA 1997 Div 711
- ITAA 1997 711-20
- ITAA 1997 711-25(1)
- ITAA 1997 711-25(2)
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- TAA 1953 Pt IVAAA

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- Murry v. Federal Commissioner of Taxation 193 CLR 605; 98 ATC 4585; (1998) 39 ATR 129
- Hepples v. Federal Commissioner of Taxation (1991) 173 CLR 492; 22 ATR 465; 91 ATC 4808

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- Explanatory Memorandum to the New Business Tax System (Consolidation) Bill (No. 1) 2002
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