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Commissioner Targets Tax Consolidation Beware Goodwill

1. Overview

As many readers will be aware, there are still a significant number of unresolved technical issues associated with the process of consolidating for taxation purposes.

Allowing for the fact that taxation consolidation has been with us since 1 July 2002 it is no surprise that this area has become a fertile ground for dispute between taxpayers and the Australian Taxation Office.

Most practitioners are now aware that tax consolidation contains significant traps for the unwary. As the decision to consolidate is irrevocable it is critical that the necessary planning is undertaken.

This article focuses on the existence and valuation of goodwill and the manner in which it may impact on the tax consolidation exercise.

2. Existence and Valuation of Goodwill

Before covering the technical issues, the potential problem is best illustrated with a simple example.

Parent company establishes a subsidiary in 2005 to commence a new business undertaking. The parent company then makes a decision to consolidate on 1 July 2009 (note, this decision can be made at any time).

The subsidiary is capitalised with \$300,000, the proceeds being used to purchase plant and equipment.

The subsidiary has an annual EBIT of around \$100,000.

To make life easy we will assume the balance sheet at 1 July 2009 is as follows:

	\$
Assets:	
Cash	200,000
Plant & Equipment WDV	200,000
Liabilities:	
Nil	
Net Assets	400,000
Paid up Capital	300,000
Retained Earnings	100,000
Equity	\$400,000

The amount used to reset the cost of assets for tax purposes is referred to as the allocable cost amount (ACA).

In this example, the ACA is \$400,000 (being the paid up capital of \$300,000 plus the frankable retained earnings of \$100,000).

Many would expect that this \$400,000 would be allocated \$200,000 to cash and then \$200,000 to plant and equipment.

Unfortunately, this is not necessarily the case as the company may have internally generated goodwill which must be taken into account in the ACA allocation.

In the first instance, it is likely that the business has goodwill in one of the various forms that it may arise. That is, there will be an attractive force which brings custom to the business.

The critical issue is to determine the value of the goodwill (should such a value exist).

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The value of goodwill generally represents the difference between the value of the business and the value of the net identifiable assets used in the business (refer F C of T v Murry 98 ATC 4585).

The Commissioner's Consolidation Reference Manual provides the following illustrative comments regarding the valuation of goodwill:

Valuations required for all assets

The cost setting process requires market valuations for all the assets (except for retained cost base assets) of the entity as at the joining time, including assets that are off balance sheet and those for which a tax cost has not previously been set. For example, all identifiable intangible assets must be valued, including goodwill ...

Market valuing goodwill

Single entity joining case

When a single entity joins a group, goodwill can be valued as a residual item: i.e., the sum of the differences between (a) the market value of each business of the joining entity and (b) the market value of the net identifiable assets of each business of the joining entity.

■ 'Goodwill' in 'Treatment of assets', C2-1; Taxation Ruling TR 2005/17

For this purpose, goodwill includes synergistic goodwill that accretes to the assets or businesses of the group as a consequence of the group's ownership and control of the joining entity. All elements of this goodwill are treated as a reset cost base asset of the joining entity even though some of the added value may accrue to assets or businesses already owned by the group.

■ subsection 705-35(3), Income Tax Assessment Act 1997; as amended by New Business Tax System (Consolidation) Act (No. 1) 2002 (No. 68 of 2002), Schedule 1; 'Goodwill' in 'Treatment of assets', C2-1

This synergistic goodwill '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.'

■ subparagraph 705-35(3)(b)(ii)

When a joining entity is being fully acquired at the joining time at arm's length in an open and transparent market, the purchase price of the entity will provide a sound indication of its market value.

Where membership interests in the joining entity have been acquired over a period of time, the market value of the joining entity is established at the joining time.

Formation case

When a group forms, either of two approaches can be adopted to determine goodwill. While the group can choose which approach to follow, the second is recommended where the transitional option of retaining existing tax costs has been applied to one or more entities.

1. The first approach is to value the joining entities on a group basis and apply the residual method. That is, all the businesses of the forming entities (or group) can be valued as well as their net identifiable assets. In determining the goodwill for the group, adjustments need to be made for intragroup transactions. The resulting group goodwill must be apportioned to the businesses (and therefore the relevant member entities) of the group on an appropriate basis; a reasonable method is in proportion to the value of the businesses.
2. The second approach is to determine goodwill on a standalone basis: i.e. the goodwill is calculated by reference only to the businesses of the entity in question. The advantage of this approach is that it eliminates the need to value all the group's net identifiable assets and goodwill and allocate that goodwill across the relevant entities. If the second approach is adopted, the following principles should be observed:
 - The entity is to be valued 'in situ' – that is, each business of the entity includes its intragroup cash flows and cost

benefits in the first instance. • Adjustments to cash flows should be made in those circumstances where the cash flows have non arm's length characteristics. The cash flows or absence of cash flows must be adjusted to represent arm's length dealing. Such adjustments should reflect the same principles that are set out in the taxation rulings dealing with international profit allocation and transfer pricing ■ TR 94/14 and TR 97/20. See also 'Example – application of the arm's length principle on formation (valuation of entity) in the determination of goodwill' below.

- Where synergies are present, the valuation of the businesses of the entity must reflect the full value of those synergies that can be determined by the amount that would be paid for the businesses by a pool of hypothetical buyers at the joining time (a component of market value). That ought to be reflected in the adjusted cash flows and will include, where present, the appropriate elements of synergistic goodwill. It should provide the market value amount that hypothetical buyers would be prepared to bid for the businesses of the entity at the joining time.
- In those exceptional circumstances where there is unique special value (sometimes referred to as unique goodwill) that is attributable to only one specific buyer (assumed to be the existing group in the formation case), this amount or value would not be included in the market value of the entity being valued.

The residual value approach is then applied to the businesses of the entity to determine the market value of the goodwill. This value will include all the relevant goodwill components including the synergistic goodwill.

■ 'Goodwill' in 'Treatment of assets', C2-1

In the present example if an earnings multiple of say 5 times was applied, the business would have a value of \$500,000.

If the net identifiable assets of the business amount to \$400,000 it follows that goodwill may have a value of \$100,000.

Before raising the issues arising from this somewhat hasty assumption we should focus on the potential implications arising in the calculation of the reset tax cost of assets in the subsidiary.

The ACA amount of \$400,000 is firstly allocated to the only retained cost asset being cash of \$200,000.

The balance of \$200,000 is allocated to the reset cost assets as follows:

Asset	Market Value	Percentage	Allocation
Plant & Equipment	200,000	66.66	133,334 (ACA balance x 66.66%)
Goodwill	100,000	33.33	66,666 (ACA balance x 33.33%)
	\$300,000	100	\$200,000

In these circumstances the written down value of plant and equipment is reduced from \$200,000 to \$133,333. That is, future depreciation deductions of \$66,666 have been lost.

The goodwill of the business now has a capital gains tax cost base of \$66,666.

The contentious issues arising in the context of a taxation audit are as follows:

1. On the assumption that goodwill exists, what is the value?
2. What is the market value of plant and equipment?
3. Is goodwill the only intangible asset or are there others which need to be identified and valued (such as copyright which may give rise to future tax deductions).

In the first instance it is necessary to determine the value of the overall business.

In the absence of an external transaction which pegs the value of the business at a contemporaneous time to the entry into the tax consolidation regime this is not a straight forward issue.

Pertinent questions include:

- Which valuation methodology should be used?
- If an earnings multiple is used, what is the business's net maintainable earnings?
- What multiple should be used?

Secondly, it is then necessary to determine the market value of the net identifiable business assets.

Valuation of plant and equipment and land holdings can give rise to a time consuming and costly exercise.

This is also obviously an area of potential dispute with the ATO.

It is critical to undertake these valuations as goodwill is the residual asset after the tangible assets have been valued.

Where the tangible net assets represent the full value of the business, goodwill will not have a value for taxation purposes.

Finally, it should be noted that there may be other intangible assets beyond goodwill which may have a value (and potentially more favourable taxation outcomes).

That is, the value of goodwill may be lower if there is an attribution of value to other intangibles.

The following intangible assets give rise to ongoing amortisation deductions for taxation purposes.

- copyright
- patents
- registered designs

The bottom line in this exercise is that independent valuations supporting the position taken are very difficult for the ATO to contest.

However, internal valuations undertaken by Directors are a fertile ground for taxation dispute.

New Trans-Tasman Tax Agreement

This article has been provided by our Baker Tilly International affiliate firm in New Zealand, Staples Rodway.

An updated Australia/New Zealand Double Tax Agreement was signed on 27 June 2009. The agreement represents the result of more than a year's negotiations between Australia and New Zealand. The key points are:

Dividends: The withholding tax rate on dividends will stay at 15% but will reduce to 5% for an investing company that has at least 10% shareholding in the company paying the dividend or 0% if the investing company holds 80% or more of the shares in the other company and meets other criteria (for example, having its principal class of shares listed on a recognised stock exchange).

Royalties: The withholding tax rate on royalties will reduce to 5% from 10%, which is a welcomed development.

Interest: The withholding tax rate on interest will generally remain unchanged at 10%. Exceptions exist if the payment of interest is made to the State or an unrelated financial institution.

Secondment Exemption: The agreement includes a 90 day exemption for an individual from tax in the country they are seconded to.

Time Bar: The agreement includes a 7 year time bar on re-assessing past tax returns. An exception to this is in the case of fraud, gross negligence, wilful default or where an audit has already commenced.

Permanent Establishment: The definition of a permanent establishment has been amended. For example, a permanent establishment will be deemed to have occurred when a dependent agent “substantially negotiates” contracts.

Application Date: The existing 1995 Double Tax Agreement will be replaced by the new treaty, which will come into force once both Australia and New Zealand have given legal effect to it.

Doing Business in the US – Beware the Tax Man!

This article has been provided by our Baker Tilly International affiliate firm in Seattle.

Although there are definite opportunities to doing business in the U.S, there are also significant challenges. Perhaps the largest of these is dealing with the complex U.S. tax laws.

The tax differential between Australia and the U.S. is significant – commonly 10% to 15 %, and in the extreme – up to 40 %!

The Australian perception that the IRS is a serious organisation that vigorously enforces U.S. tax laws is accurate. U.S. taxes are perhaps the highest in the world and enforcement is strict, much stricter than in many places such as Asia. The IRS is especially strict in administering transfer pricing policies and any attempt to strip profits out of the U.S. back to Australia through transactions and charges. Businesses will have to navigate around transfer pricing rules in both countries.

Individual State Taxes

Tax rates differ significantly. An Australian company pays a flat 30% income tax rate. That number could be significantly higher in the U.S., where the federal income tax rate is up to 35%. In addition, many of the 50 states have income taxes that vary from state to state and range up to 10%. Furthermore, the individual states are not parties to international income tax treaties. This means that protections that Australians may assume they have from U.S. taxes under the Australian—United States Income Tax Treaty may not protect them from state taxes.

Dividend Withholding Tax

Australian businesses will also be liable for a U.S. dividend withholding tax when profits are repatriated to Australia. Depending on how the Australian business is structured going into the U.S., there could be additional taxes. If the Australian owned U.S. business is structured as a C Corp and more than 10% is held via an Australian company, it will pay 5% withholding tax. Otherwise, the U.S. dividend withholding tax could be as high as 15%. Add that up and it could be greater than 50% of every dollar earned on U.S. taxes!

Sales tax

Most individual states also have a sales tax. Unlike Australia's GST, not all sales taxes are automatically passed on to consumers and are easily tracked.

Impact on personal taxes

Another major issue for privately held Australian companies is how the U.S. tax laws impact the personal taxes of the owners of these companies on eventual repatriation of U.S. profits to these owners. With one of the highest personal individual tax rates in the world, this is especially important to Australian owners who are seeking to maximize after-tax returns from their offshore operations.

Death taxes

In addition to income and sales taxes, Australian individuals with US business interests could be subject to US estate taxes upon death. US estate taxes are based on the fair market value of the assets held at death, with rates as high as forty five percent.

Choosing the right structure

Most businesses that enter the U.S. expect that their business will succeed and produce significant profits, however, many business owners make the mistake of waiting until they have established their business before getting advice. This could cost them significantly in the long run. It is therefore imperative to choose the right structure from the beginning.

As the type of structure is contemplated, consideration should also be given to an exit strategy and to ensuring that any available tax relief is accessed if the business does fail. It is best to create a structure that considers the possibility of both losses and significant appreciation and that is flexible enough to get benefits on both sides, but not necessarily the maximum benefit on either side.

Funding

Another question to be answered is how the business will be funded. Will the business be capitalised with debt or equity, and in what proportions?

In the U.S. there are earning stripping rules, that may limit the ability of the U.S. subsidiary to deduct interest paid to a related party. Similarly, Australia has its own thin capitalisation rules, that can permanently deny debt deductions for Australian businesses with controlled offshore entities or offshore businesses. The balance between debt and equity needs to be carefully determined to comply with both jurisdictions whilst maintaining commercial flexibility.

Employees

Australian entities doing business in the United States must also be aware of U.S. employment taxes and employee rules. In general, it is better for Australians to work in the U.S. under a visa rather than a green card. Australian employees must comply with IRS rules, and they must file U.S. tax returns. Australians working in the U.S. must have the appropriate visa, know how much time they can stay and work, and understand the tax impact of their compensation package.

Creative Solutions

To try to nullify the challenges of doing business in the U.S, creative solutions as to how to structure a business, do exist. A business can be structured as a Limited Liability Company (“LLC”) or a Limited Liability Partnership (“LLP”), as an example. How the business is structured in Australia may allow the Australian business to adopt transparent tax

outcomes, and to get full foreign income tax offsets for U.S. taxes. However, such structuring is complex particularly from a U.S. tax perspective.

With potentially high tax rates, taxes that vary among the 50 states and possible estate taxes, there is no doubt that U.S. taxes are a significant business cost, and the U.S. tax code is complicated. But it is also the land of many opportunities. For Australian companies intent on taking advantage of those opportunities, early planning and expert execution can significantly improve the after tax profit potential.

Trading Stock – Treatment of Discounts, Rebates and Other Trade Incentives Offered by Sellers to Buyers

Introduction

The ATO has released a final tax ruling setting out its views on the income tax consequences for buyers and sellers of trading stock where:

- trade incentives in the form of discounts, rebates or other incentives are received by the buyer from the seller that are directly connected with the buyer's purchase of trading stock; and/or
- trade incentives or other payments are received by the buyer from the seller that, while not directly connected with the buyer's purchase of trading stock, are:
 - in consideration for the buyer providing a service in relation to the trading stock; or
 - to secure a real commercial benefit for the seller in relation to its brand or the future sale of its goods.

Trade incentives that relate directly to the purchase of trading stock

Trade incentives that relate directly to the purchase of trading stock are treated as a reduction in the cost of acquiring the trading stock for the buyer for the purposes of section 8-1 (the general allowable deduction provision) and Division 70 (which contains the trading stock rules).

Similarly, trade incentives that relate directly to the sale of trading stock will be regarded as a reduction of the sale proceeds for the seller for the purposes of section 6-5 (the general assessable income provision) and Division 70.

Trade incentives that are subject to condition that has not been satisfied at the time of the purchase

In the hands of a buyer, an incentive that is subject to a condition that has not been satisfied at the time of the purchase:

- will not be directly related to the purchase of trading stock;
- does not reduce the cost of acquiring trading stock for a buyer; and
- will be ordinary income of the buyer and derived in the income year in which it is earned (where the buyer is an accruals basis taxpayer) or in the year it is received (if the buyer is a cash basis taxpayer).

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From the perspective of the seller, the general rule will 'mirror' that of the buyer. That is, the incentive will:

- not relate directly to the sale of trading stock;
- not reduce the proceeds of sale for the seller; and
- be deductible as a business expense in the income year in which it is incurred

The exception to the above general rule for the seller is where there is virtual certainty at the time of sale that the condition will be satisfied. For example, a settlement discount that is always taken by the buyer will reduce the sale price for the seller. Similarly a volume rebate subject to a rebate threshold that has not been met but is certain to be met will reduce the sale price for the seller. In both instances the seller's assessable income from the sale will be the reduced amount.

This exception to the general rule for the seller means that there will be a 'mismatch' between the positions of the buyer and the seller in such a case – i.e. as the condition has not actually been satisfied at the time of the purchase the buyer will be claiming a tax deduction based on the 'gross' amount whereas the seller will be reporting assessable income using the 'net' sales price as there is virtual certainty at the time of sale that the condition will be satisfied (see Example 5 below).

Trade incentives that are provided for future acts and/or services

Where a trade incentive is provided:

- in respect of future acts and/or services (such as promotional services) to be performed by a buyer; and
- where the buyer is required to repay or in practice repays any part of the trade incentive attributable to any acts and/or services not performed,

the trade incentive is not directly related to the purchase of trading stock and will only be assessable income of the buyer at the time that the relevant acts and/or services are performed.

Similarly, in the hands of the seller such a trade incentive does not relate directly to the sale of the trading stock; will not reduce the proceeds of disposal for the supplier; and will only be a deductible loss or outgoing for the seller in the income year in which it is incurred.

Summary of the factors that the ATO will take into account in determining whether a trade incentive directly relates to trading stock

Factors relevant to whether a trade incentive reduces the cost of acquiring trading stock for a buyer and the proceeds of disposal for the seller include:

- the terms of trading between the parties and other sales and transaction documentation – such as invoices, incentive claim forms and credit notes;
- an objective assessment of the intention of the parties; and
- any other relevant circumstances surrounding the payment of the incentive.

Where a trade incentive is paid for more than one purpose, each purpose is considered in determining the extent to which the payment reduces the cost of acquiring trading stock for the buyer and the proceeds on disposal of the

trading stock for the seller. If apportionment between each purpose cannot be accurately measured, the buyer should return the full amount of the trade incentive as income and the seller should return the full amount of the trade incentive as a business expense.

Some of the Twelve Examples Provided by the ATO in the Ruling

Example 1 – upfront volume rebate not subject to aggregate volume threshold – buyer and seller

15. Under its terms of trade with a seller, a buyer is entitled to receive a volume rebate of 5 per cent for all purchases of 5,000 or more items of trading stock. The buyer purchases 10,000 items of trading stock with a cost price of \$20 per item subject to the 5 per cent rebate.

16. The volume rebate is intended to reduce the selling price of the goods under the terms of trade in accordance with ordinary business practice. It is treated as a reduction in the cost of the purchase of trading stock by the buyer.

17. The volume rebate reduces the buyer's acquisition cost of the trading stock. The buyer's acquisition cost of the trading stock for income tax purposes is \$190,000.

18. Similarly the volume rebate reduces the sale proceeds of the seller for income tax purposes to \$190,000.

19. Whether or not the volume rebate is included on the sales invoice or is separately invoiced would not affect the income tax consequences. In the circumstances the volume rebate is in substance simply a reduction in the purchase/sale price, and the manner in which it is invoiced would not alter its character.

Example 5 – characterisation of trade incentive – settlement discount always allowed – buyer and seller

36. Over a number of years a buyer's terms of trade with a seller have included an entitlement to a prompt payment discount where payment is made within 30 days. The buyer has always claimed the prompt payment discount whether or not it pays the invoice within 30 days, and the seller allows the discount without objection.

37. Despite what occurs in practice the prompt payment discount is an incentive subject to a condition that has not been satisfied at the time of purchase and will not reduce the cost of acquiring trading stock for the buyer. The amount incurred by the buyer for the purposes of section 8-1 is determined by the contractual terms of trade between the parties, and at the time the transaction is implemented the buyer has no right to the prompt payment discount. The fact that the seller always allows the prompt payment discount is something that occurs later and does not reduce the amount that the buyer has incurred under the contract.

38. The buyer will include the amount of the discount in its assessable income in the income year in which its entitlement to the discount arises.

39. As it is certain that the prompt payment discount will be taken by the buyer and allowed by the seller, the prompt payment discount will reduce the sale price for the seller. The seller's assessable income from the sale will be the reduced amount. To include the gross sale price in the assessable income of the seller would... produce a 'misleading' result.

Example 8 – promotional rebate derived when services performed – buyer; promotional rebate incurred when liability arises – seller

48. On 31 May a buyer purchases trading stock from a seller and receives from the seller a trade incentive in consideration for promotional services to be performed by the buyer over the following three months. To the extent that the services are not performed the buyer is required to make a pro rata repayment of the trade incentive to the seller.

49. The buyer performs the promotional services over the three months period in accordance with the agreement with the seller.

50. The incentive is derived by the buyer for the purposes of section 6-5 over the three months period. One third of the amount paid is derived as at 30 June with the remaining two thirds derived in the following income year. Any monies received or receivable by the buyer as at 31 May are subject to the discharge by the buyer of certain future obligations. The assessable income of the buyer as at 30 June will include that proportion of the trade incentive representing obligations discharged, and therefore income earned, as at 30 June.

51. The seller incurs a deduction for the incentive on 31 May. In the event that the buyer did not fully perform the relevant services and was required to repay or credit a part of the promotional rebate representing the unperformed services, the amount repaid or credited to the seller would be ordinary income and assessable income of the seller.

Example 10 – unapportioned bundled rebate – buyer and seller

57. Under its terms of trade with a seller, a buyer is entitled to a 4 per cent rebate on certain major brand goods. The rebate is intended to cover a range of trade incentives and, in the interests of administrative efficiency and to minimise costs, the parties do not dissect the rebate into its component parts.

58. As neither the buyer nor the seller can make a bona fide estimate of the amount attributable to the promotional activity, the buyer's cost of an item of trading stock is the undiscounted amount and the seller treats the undiscounted amount as the sale proceeds. The buyer should return the 4 per cent rebate as income and the seller should claim the 4 per cent rebate as a business expense.

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