Under review, new publication being developed

SOUTH AUSTRALIA

STATE TAXATION OFFICE

Stamp Duties

Circular No. 166
(replaces Circular No. 87)

VALUATIONS

This Circular extends the material presented in Circular No. 87, particularly in the determination of goodwill.

This Circular is issued for the information of the members of professional bodies and persons lodging documents at the State Taxation Office for the assessment of stamp duty and reflects consultation with:

- Australian Society of CPA's
- The Institute of Chartered Accountants in Australia
- The Law Society of South Australia
- National Institute of Accountants
- The Taxation Institute of Australia
- Taxpayers' Association of South Australia

The current methods and practices used by the State Taxation Office in valuing property to determine duty are described in general terms by this Circular.

Valuations with respect to the following types of property are covered:

- real estate
- shares
- units in unit trust schemes
- insurance policies
- life interests
- partnership interests
- goodwill
- leases
- contracts for sale and purchase, and
- businesses.

Value

The word "value" has no general statutory definition. Valuation is a process of estimating worth, which may include the determination of book value, replacement value, reproduction value, intrinsic value, break up value, depreciated value, fire sale value, going concern value, special value and market value. The object of the methods suggested here is to determine the market value of a property for stamp duty purposes.

Section 60A(1) of the *Stamp Duties Act 1923* ("the Act") states:

> "....a reference in this Act .... to the value of property conveyed or transferred is a reference to the market value of the property...."

The following practices are consistent with the dictum of William J in *Abrahams v The Federal Commissioner of Taxation*, (1944) 70 CLR 23, 29 where it was stated that market value is:

> *"the price which a willing but not anxious vendor could reasonably expect to obtain and a hypothetical willing but not anxious purchaser could reasonably expect to have to pay ... if the vendor and purchaser had got together and agreed on a price in friendly negotiation ..."*

The Commissioner is given a discretion in Section 60A(2) of the Act to adopt the consideration for sale as being the value of the property conveyed or transferred unless it appears to the Commissioner that the consideration may be less than the market value of the property.

Section 60A(3) of the Act authorises the Commissioner to cause a valuation of the property to be made for assessment purposes where no evidence of the value of the property, conveyed or transferred or comprising or forming part of the consideration for the conveyance, is furnished to the Commissioner or the evidence so furnished is, in his opinion, unsatisfactory.

Matters to be considered

All aspects of property are to be considered in determining its market value. Certain aspects will increase the value while others will have a decreasing effect. Valuation should take into account these aspects with suitable weights in appropriate circumstances .

Two issues raised are:

1. the fact that there may not be an open market for certain properties, and
2. in certain instances, the consideration for conveyance will be fixed by rules governing the property.

An example of the first is a partnership interest which may not have a market due to the partnership agreement(s).

An example of the second is the sale of a share in a private company the price of which is fixed by the Articles and where shareholders have a right of pre-emption over the transfer of shares.

The technique of valuation in these cases will be to determine the market value ignoring this depreciating factor, and allow a suitable discount to the determined market value to account for the depreciating factor.[1]

For example, a partnership agreement may state that an outgoing partner should transfer his or her interest to an existing partner and the consideration will be the sum of that partner's balance in capital and current accounts and a further sum of $100 for goodwill. The partnership goodwill of the partner (excluding personal goodwill) was determined by a mutually acceptable method between this Office and the taxpayer. The calculated value of $200 does not include personal goodwill.

What is the market value of the partnership interest? Is it:

- the sum of the account balances and $100 consideration for goodwill, or
- the sum of account balances and the $200 computed, or
- a value in between?

The $100 consideration is one of the elements that went to make up the total value of the partnership interest. In addition to that consideration, ownership of the partnership interest together with goodwill of a partner, gives the holder a number of valuable rights such as the right to receive super profits of the partnership, the right to pledge his or her interest in the partnership to a lender for purposes of borrowing or as a guarantee, recognition in business or professional circles, the right to alienate income to the spouse, participation in a service entity through a family trust vehicle etc. Consequently the value will be "a value in between". (In practice this Office will arrive at this figure after consultation with the parties concerned).

Arm's length transactions

Since the publication of Circular No. 87 some practitioners have questioned the need for the Commissioner to call for accounts etc, when parties to a contract are strangers and are (hypothetically) dealing with each other at arm's length. Dealing with each other at arm's length is a legal concept. The fact that two total strangers have struck a bargain does not conclusively indicate that they are dealing at arm's length. The issue that needs to be determined is whether each party has been 'acting in his or her own best interest'. If the answer is yes, they are acting at arm's length. Lee J in *Granby Pty Ltd v FCT* 95 ATC 4240 page 4243 said: *"The expression 'dealing with each other at arm's length' involves an analysis of the manner in which parties to a transaction conducted themselves in forming that transaction. What is asked is, whether the parties behaved in the manner in which parties at arm's length would be expected to behave in conducting their affairs. Of course, it is relevant to that enquiry to determine the nature of the relationship between the parties, for if the parties are not parties at arm's length the inference may be drawn that they did not deal with each other at arm's length".*

[1] *Inland Revenue Cmrs v Crossman* [1937] AC 26; [1936] 1 All ER 762.

The following definition from *Black's Law Dictionary*, 5th ed, page 100 that has often been quoted in tax cases: *"Arm's length transaction. Said of a transaction negotiated by unrelated parties, each acting in his or her own self interest; the basis for a fair market value determination. Commonly applied in areas of taxation when there are dealings between related corporations, eg parent and subsidiary.* *Inecto Inc v Higgins, DCNY, 21* F Supp 418. *The standard under which unrelated parties, each acting in his or her own best interest, would carry out a particular transaction. For example, if a corporation sells property to its sole shareholder for $10,000, in testing whether $10,000 is an 'arm's length' price it must be ascertained for how much the corporation could have sold the property to a disinterested third party in a bargained transaction."*

REAL ESTATE

Valuation and charges for making a valuation are covered by Circular No. 27. For convenience, the relevant portions of this Circular are quoted below.

Circular No. 27

"WHEN WILL A VALUATION BE REQUIRED

Where the parties are related either through a family group or through a corporate group a valuation ***will*** *be required.*

The transfer of portion of the land or a fractional interest in an existing parcel ***will*** *require a valuation of the portion being conveyed.*

A valuation is ***not*** *required in cases where the consideration expressed in the document represents a full market price in the opinion of the parties who are unrelated and bona fide sellers and purchasers. In these cases, the contracted and declared sale price will normally be accepted.*

However, should the consideration or value declared be in the opinion of the Commissioner, unsatisfactory, a valuation may be undertaken.

Note: The fee for a valuation will only be charged if the value determined by the valuer appointed by the State Taxation Office exceeds the value submitted by the taxpayer/lodging party by greater than 10% of the taxpayer's value.

TAXPAYER'S VALUATION

In cases where the taxpayer or his/her agent provide a recent valuation by a suitably qualified practitioner, that valuation will generally be used (subject to the Commissioner being satisfied) for the purpose of assessing duty.

A suitably qualified practitioner will, in the case of real estate, be a member of the Australian Institute of Valuers and Land Economists.

To be accepted by the State Taxation Office this valuation will need to be:-

no more than six months old at the time of lodging documentation for the opinion of the Commissioner of Stamps;

or

made within six months from the date of the instrument.

Where the valuation is outside the periods referred to above, it will be necessary for the valuer to certify that at the date of the sale and/or conveyance, the circumstances in relation to the property had not changed from the time that the valuation was performed.

ACCESS TO VALUATIONS

Where the Commissioner of Stamps appoints a valuer to undertake a valuation in respect of any property, the taxpayer may seek and be supplied with a copy of such valuation.

SOME COSTS TO BE PASSED ON

The State Taxation Office has been requested to pass on the cost of the valuation to the taxpayer in cases where the purchase price or value declared by the taxpayer or his/her agent is more than 10% below the market value determined by the valuer appointed by this Office.

It should be noted that where the value declared by the taxpayer or his/her agent or the consideration expressed in the transfer is within 10% of the valuation obtained by this Office, ***no charge will be made****.*

It is therefore important for lodging parties to declare a realistic value for the property otherwise a valuation fee may be incurred.

AMOUNT OF CHARGE

Where the valuation fee is to be passed on, the actual cost incurred by the State Taxation Office will be charged to taxpayers.

The Valuer-General's charge for real property valuations is currently $100 per hour with a minimum charge of $50.

In the majority of real property valuations, where the State Taxation Office appoints the Valuer-General to determine a value "for stamp duty purposes," the charge is likely to be $50."[2]

SHARES

Private companies

Due to the complexity of the subject only a broad outline is given here. In view of the assumptions that may need to be made in share valuations, professional advisers may calculate the value of a share by any standard method of valuation, such as:

- Net Asset Basis
- Earnings Basis
- Dividend Basis

When a share transfer instrument is lodged, it is expected that the following documents will be provided:

- Memorandum and Articles of Association (The documents need not be provided if the company has only one class of shares);
- Profit and Loss Statements for three years immediately prior;
- Balance Sheets for prior years (generally three years); and
- A valuation report, if one has been produced by a professional adviser.

This list is not exhaustive. The number of prior years in relation to which the financial statements are required will depend on:

- Nature of the industry to which the company belongs
- Position of this company in the industry
- Whether the company is service-oriented or otherwise
- Whether the company is capital intensive, labour intensive or asset rich
- Any other special circumstances

Stamp duty is charged on the conveyance of a property. If a parcel of shares is transferred by a single share transfer instrument, that parcel is considered a single unit of property for stamp duty purposes. Consequently it should be valued as a parcel after taking into account the totality of that parcel of shares.

[2] Now $55.00.

The following list, again not exhaustive, will be useful in calculating the premiums and discounts mentioned above and the share valuation in general:

- Size of the parcel in relation to all issued shares of that class
- Voting powers attached to the parcel
- Any restriction upon the transfer of shares
- The nature of management
- History of the industry
- Prospects of the industry
- History of the company
- Prospects of the position of the company
- The profit earning capacity of the company
- Yield on quoted shares in the industry
- The risks involved
- Return on purchase of the investment
- Capital position of the company
- The basis of value of assets
- The amount of liabilities
- The effect of inflation and recession.

The usual practice adopted by this Office is to exclude or add back non-commercial and extraordinary items (eg, directors' fees, salaries, interest and superannuation contributions) disclosed, to determine the earnings of the company for a year. The average earnings over the past three years of income, with appropriate weights to each year, will yield the maintainable profit for the succeeding years. A capitalisation factor will then be applied to the maintainable profits to determine the value of the business of the company as a going concern.

If a company has different trading arms, it would be prudent to determine the going concern value of each of these divisions. This Office has no rigid position on the allocation of weights, but weights in the ratio of 1:2:3 for the past three years' earnings will be acceptable in a rising market. If not, a simple average should be sufficient. As far as the capitalisation factor is concerned, it would be acceptable if the long term Government Bond Rate, plus a percentage of 10% to 20%, is used depending on circumstances. These rates will eliminate the adjustments on account of income tax paid or payable by the company.

The going concern value arrived at in this manner will include any goodwill disclosed or not disclosed in the accounts.

In certain instances, the asset value of the company will be considered when making the valuation. The going concern valuation envisages that there is no supervening insolvency or that there would be no significant curtailment of activities of the company leading to insolvency, and that the assets of the enterprise would be continued to be kept in the same integrated form. If it could be foreseen that an asset rich enterprise is no longer a going concern but a "losing" concern on account of a long history of losses or subnormal profits, the going concern valuation is inappropriate and an assets basis of valuation will be adopted.

Public companies

Unlisted

If there is a regular market for such shares, then a letter from the Secretary of the company listing the shares that have been traded recently, detailing the number, dates and price paid, may form the basis of the valuation. Otherwise, the practice adopted for the valuation of shares in private companies should be followed.

Listed

In the case where listed shares are being purchased the closing price quoted by the Australian Stock Exchange on the day of the sale will be compared against the consideration paid for the shares to ensure the purchase price is "reasonable". If the transfer is for "no consideration", the average price quoted by the Exchange will be taken to represent market value.

UNITS IN UNIT TRUST SCHEMES

Unlisted - Public

If the Manager of the Unit Trust publishes a daily buy back price then that price will usually be adopted. If no such price is published then those practices outlined in the paragraph titled "Units - Private" will be adopted.

Listed - Public

Treated in the same manner as listed public company shares.

Units - Private

A unit trust is not a legal entity and, therefore, the valuation of a unit is different from the process of the valuation of a share. A unit holder has a proportional interest in each and every asset which is the subject of the trust. When a unit is transferred, there is a conveyance of an undivided proportional interest in every asset subject to the trust. In determining the total value of the assets to which unit holders are entitled, a deduction should be made from the total value of all assets owned by the trust on account of the trustee's right of indemnity[3] (this generally includes all debts incurred by the trustee, as a trustee carrying out the business of the trust, or incurred in his/her performance as a trustee). Undistributed profits or reserves of the trust, or distributed profits or reserves of the trust which are not drawn by the unit holders will not be taken as part of the trustee's right of indemnity. However, loans given by the beneficiaries to the trust in their individual capacity - and not as beneficiaries - will be taken as part of the trustee's right of indemnity. The determination of this aspect is a question of fact.

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[3] *Chief Commissioner of Stamp Duties v Buckle* [1998] HCA 4 (23 January 1998).

A trading trust may also have goodwill which may not be disclosed in the accounts. The goodwill will be ascertained by determining the going concern value of the business of the trust in the manner set out under “Private Company Shares” and then deducting from that value, the net asset value of the business of the trust.

LIFE INSURANCE POLICIES

A statement of the surrender value of the life insurance policy from the insurance company which holds the policy is accepted by this Office in situations where the beneficial interest passes by assignment.

LIFE INTEREST AND REMAINDER INTEREST

Where a life interest or a remainder interest in property is to be conveyed, the value of the underlying property will be ascertained in accordance with the principles and practices outlined in this Circular. The value of the interest passing will be determined with reference to tables produced by an actuary. For example:-

Value of life interest of 52 year old female

Property Value	=	$50,000	
Life Tenant Factor	=	.75776 (from Actuarial tables)	
Life Interest	=	$50,000 x .75776 =	$37,888
Remainder Interest	=	$50,000 - $37,888 =	$12,112.

PARTNERSHIP INTERESTS

Please refer to Circular No. 165 which outlines the methods used by this Office when assessing stamp duty payable on conveyances of interest in partnerships.

GOODWILL

Goodwill that this Office seeks to value is the intangible property which is capable of being bought, sold, transferred or conveyed. Personal goodwill cannot be bought, sold, transferred or conveyed.

Several publications have been written on the concept of goodwill, its nature and valuation. It is not the purpose of this Circular to revisit those concepts. The aim of this Circular is to set out certain parameters and criteria within which practitioners can quantify a value for goodwill that will be acceptable to both this Office and the taxpayer. This recognises that the calculation of the value of goodwill is the result of a number of value judgments, and consequently there can be no precise measurement. The aim, therefore, is to arrive at a value that will be “satisfactory” to all interested parties.

The super efficiency of a going concern generates goodwill. This goodwill is the worth of the future super profits, if any, of a business undertaking. The following example shows the concept of super profits and super efficiency.

Consider two identical businesses that have identical requirements of capital, labour and management and situated adjacent to each other. It is found that one generates a higher profit than the other. This higher or super profit is an indicator/measure of the goodwill of the more profitable business. In the absence of any other indicators, this Office would take the view that the future worth of the super profit is the goodwill of that business.

This Circular's emphasis is on "the question of fact." The existence of goodwill, the calculation of it and the attribution of it, are all questions of fact. There should be minimal dispute and litigation between this Office and the taxpayer if these three facets are dealt with by practitioners when ascertaining all necessary facts presented to this Office.

Question of Fact

Goodwill is inseparable from the business to which it adds value. Lord MacNaghten in *IRC v Muller & Co's Margarine Ltd.,* [1901] A.C. 217 said, "*The goodwill of a business is one whole, and..must be dealt with as such...goodwill has no independent existence. It cannot subsist by itself. It must be attached to a business.*" However, in *FC of T v Krakos Investments Pty Ltd,* [1996] ATC 4063 Hill J said, after referring to this proposition, "*Whether this proposition is universally correct must be doubted. For example, a business may have both goodwill attaching to a name and goodwill attaching to premises. There seems no reason why each of these aspects of goodwill of such a business could not be dealt with separately*." After referring to other cases, Hill J said, "*I would see as the correct position, namely that the question whether goodwill of a public house in all its elements attaches to the land on which that business is conducted, is a question of fact to be determined by reference to the facts of each case*".

Further, in rejecting the argument that the goodwill of a licensed hotel is necessarily attached to the land upon which the hotel was erected, Hill J said, *"The goodwill of a public house is like other businesses, in part referable to locality, in part to the way in which the business is conducted, in part to the personality of the publican and, perhaps, in part by the name of the public house to which some reputation may attach".*

For example, the vexed question of whether goodwill is attached to a site on which a business is situated, is seen from the following example.

Take the case of two similar adjacent businesses, the first with a corner location and the other on an interior lot in a shopping mall. Both businesses have the same labour management and capital requirements (dollar wise) but the first business because of its corner location, generates 10% more sales than the second. After allocation of income to the three agents of production, that is land, labour and management, the net income of the first is 25% more than that of the interior business. The net income capitalised by the same factor, yields 25% more capital value to the first business than to the second. If on a weekend both businesses exchange places, the capitalised value of the first business will diminish and the capitalised value of the other business will increase.

Is the increased value of one over the other because of business goodwill or site goodwill? According to the above analysis, it is attributable to the site. This attribution is solely due to analysing the facts of the case.

It is this sort of analysis, on a pragmatic basis, that this Office seeks from the practitioners and taxpayers on the question of goodwill.

Judicial concepts

The following concepts, which are not exhaustive, indicate some circumstances under which goodwill is recognised:

- Goodwill is the benefit and advantage of the good name, reputation and connection of a business.[4]

- It is that which adds value to a business by reason of situation, name and reputation, connection, introduction to old customers, and agreed absence of competition or any of these and other things.[5]

- It is every positive advantage that has been acquired by the owner carrying on a business, whether connected with the premises in which the business was previously carried on, or with the name of the firm or with any other matter carrying on with it the benefit of the business.[6]

- The goodwill of a business is a composite thing referable in part to its locality, in part to the way in which it is conducted and the personality of those who conduct it, and in part to the likelihood of competition. Many customers have mixed motives in conferring their custom to the business.[7]

Thus goodwill may arise out of one or more of trade name, location, personality of the person carrying on the business and the monopoly status of the business.

Partnerships

The "non goodwill" firms, as a whole, do have goodwill as a result of both the name and/or the reputation of the firm.[8] The fact that on the admission of a new partner or on the retirement of an existing partner, no amounts are paid in consideration of goodwill is not conclusive evidence for the non existence of goodwill. A clause in the partnership agreement that "the partners hereby agree and declare that the partnership has no goodwill and a partner who dies or retires or is expelled from the partnership shall have no claim to any payment of goodwill" is again not conclusive. The mere agreement among the partners that the business has no goodwill does not mean that the business has "in fact" no goodwill.[9] Again the quantum of goodwill will depend on the future maintainable super profits.

[4] *IRC v Muller & Co's Margarine Limited* [1901] A.C. 217.
[5] ibid
[6] *Churton v Douglas* [1859] Johns, 174.
[7] *FCT v Williamson* [1943] 67 CLR 561.
[8] *Hill v Fearis* [1905] 1Ch 466.
[9] *Foster v Commissioner of Stamps* [1966] WAR 144.

However, in the case of the service oriented industry (generally in law, accountancy, medical or other similar professions) the major portion of the excess profits could be due to personal goodwill. Most of these professional practices are partnership concerns.

Service entities

This Office regularly encounters service entities during the valuation of goodwill of professional partnerships. Invariably, the entire professional income is initially derived by the partnership and then a substantial portion of it is allocated to a service entity - a unit trust, company etc - and the net income is distributed to the partners. This Office will continue to ascertain and calculate the goodwill of both entities as a single entity after making due adjustments for the notional salaries of partners - based on current market rates - and attribute the determined goodwill to the partnership even though it may not be the primary income earning entity.

Calculation

The quantum of goodwill is the excess of the value of the going concern over the net asset value of the enterprise. One should ensure that a risk rate is included in the discount factor when a going concern value is arrived at using discounting techniques.

Personal Goodwill

This Office recognises that the goodwill of a partnership will include the personal goodwill of the partners. The determination of that quantum of personal goodwill is a question of fact. This Office's experience during the past few years has been that in the case of a professional partnership (of lawyers, doctors, accountants, engineers, computer consultants etc) the personal goodwill will consist of fifty per cent of the total goodwill of the partnership. Consequently this Office will seek to assess only fifty per cent of the calculated goodwill. If any lodging parties believe that the percentage of personal goodwill is greater than fifty percent in a particular case, the party should provide adequate evidence to support that contention. It is accepted that in extreme cases, the entire goodwill could be personal goodwill.

In summary, goodwill is calculated by the capitalisation of maintainable profits, or by the capitalisation of super profits, or by rule of thumb methods which use gross fees received, net income received, number of clients, number of articles sold, etc, each of which has particular merits. However, all these methods except the first one (that is the capitalisation of maintainable profits) involve using more than one variable and produce a result which will not be useful in arriving at a satisfactory figure for goodwill, acceptable to both the taxpayer and the State Taxation Office. It is because of this factor that this Office will adopt the maintainable profits/super profits approach.

LEASES

On the assignment of a lease where there is no other property passing, and it is not a part of a sale of a business or wider transaction and no consideration is paid, it will generally be accepted that the lease has no inherent value. However, in accordance with Section 71 of the Act a value must be declared in the instrument, albeit nominal.

If, in any case, it appears that there is a value by reason of its advantageous terms, then a valuation will be required. The valuation will depend on factors such as the number of years of lease remaining, a comparison of the rent of the property with comparable properties etc.

CONTRACTS FOR SALE AND PURCHASE

On an assignment of a contract for the sale and purchase of any property, this Office will usually value the property on the amount of deposit paid. If the contract is an old contract, then in addition to the amount of the deposit, this Office will value the property having regard to any appreciation in the property since the date of the contract.

If a development approval or other advantage has enhanced the value of the property that is the subject of the contract, then those matters are to be disclosed and will be considered in assessing the value of the property.

BUSINESSES

It is usual to expect that a business is made up of a number of separate items. In many cases those items include a leasehold interest in land, plant, fixtures and fittings, stock in trade and debtors. There are many other items making up a business, including intangibles such as business names, statutory licenses, trademarks, copyrights and other forms of intellectual property.

In most cases, provided the parties are dealing with each other at arm's length, the consideration being paid or given will generally be accepted as representing the appropriate value of the business. The consideration paid will be accepted if all the parties to the transaction were advised by independent professional consultants.

If there is any assumption of liability then it will be added to the consideration actually paid to determine the real consideration.

Where stock in trade is involved, either a certificate of a valuer as to the value of the stock on hand at the date of the conveyance, or evidence that both parties have agreed to the value of the stock, is required. The latter is usually provided by a letter or letters signed by all interested parties.

Goodwill is usually treated in the manner described elsewhere in this Circular.

In situations involving the conveyance of intellectual property, it is generally accepted that the consideration being paid by the parties for the intellectual property represents its market value. If this Office is dissatisfied, then a valuation of such property from an independent valuer who is familiar with the appropriate methods of valuation of that property, will be required.

In respect of tenants' fixtures and fittings, again this Office will usually accept, in an arm's-length transaction, that a proper price is being paid by the purchaser. If this appears unsatisfactory, again a valuation by a suitable valuer is required.

These are general principles within which each case will be examined on its own merits. On occasions it may be necessary to depart from these practices if warranted by the particular aspects of a case. This is in accordance with the philosophy outlined in the following quotation:

> "What is called a theory of appraisal is a systematic treatment of two problems that arise in the valuation of property. The first problem is to secure a definition of value acceptable for the purpose of the particular inquiry. The second problem is to determine the method by which quantum of this value is to be estimated."
>
> J C Bonbright, *Valuation of Property*, (McGraw Hill, 1937, page 10).

FURTHER ENQUIRIES

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COMMISSIONER OF STATE TAXATION