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When it comes to valuations, make sure the price is right

TAX

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By Mark Whittaker and Sally Preston•09 December 2022•10 minute read

Whether you're preparing for succession, planning a restructure or thinking about selling, the ATO will have questions about the value of your business. The updated ATO guidance makes it clear that it's your responsibility to give an accurate answer — with steep penalties and unwanted tax bills for those who get it wrong.

Fortunately, the ATO's updated guide *Market Valuation for Tax Purposes* outlines how you can get it right.

The guide details the Commissioner's general expectations on market valuations for tax purposes, including what market value means and the evidence and processes the ATO generally expects to see as support for a valuation. It sheds light on what is often a complex area.

When do I need a valuation for tax purposes?

First, let's clarify when you may need to determine the market value of your business for tax purposes. The potential applications are considerable, in fact, the Inspector General of Taxation found there are at least 206 different tax provisions that may require you to determine "an unrealised value of an asset or liability, or an alternative value to a realised asset or liability".

Some examples of these provisions include:

- The market value substitution rule, which may apply where parties have not dealt with one another at arm's length. For example, where an asset has been transferred between family members for minimal or no consideration the CGT may be calculated based on the market value of the asset instead of the sale price.
- The $6 million net market value asset test, under which small businesses that are valued at less than $6 million may access CGT concessions.
- Allocating the proceeds from a business sale to the various tangible and intangible assets of the business, some of which may be pre-CGT.

How can I value my business?

You need to determine the market value of your business so what does that actually mean? Unfortunately, the answer is: it depends. It's also something many businesses are actually allowed to attempt themselves, however this is not always recommended as a reasonable estimate of market value requires skill, knowledge, and experience. The ATO will generally look more favourably on a valuation prepared by a professional valuer.

Market value is a tricky concept, one based more on process than outcome. The guide itself acknowledges that generally there is no one definition for market value, as determining market value requires careful consideration of the asset, business or entity, environment, market and any other relevant factors.

The guide notes that the ordinary meaning of market value should be based on case law and the International Valuation Standards Council (IVSC). However, the case law and IVSC don't exactly provide a how-to on reaching market value, instead opting for more of a toolkit of different approaches that can be adopted, with different methodologies appropriate depending on the circumstances. Ultimately, valuation is a bespoke process that relies on significant expertise.

Noting this, the ATO has summarised eight key fundamentals of valuation:

1. A valuation should be specific to the tax and superannuation provision that it is being applied to and consider any requirements of the relevant provisions, having considered case law and relevant ATO guidance.
2. Market value is conceptually distinct from historical cost (the original price that is paid for goods or a service, or the amount paid to produce the goods or services by the relevant entity).
3. The nature and source of the valuation inputs must be consistent with the bases of value (relevant facts and assumptions) and the valuation purpose (tax or superannuation provision).
4. The valuer should adopt the most relevant and appropriate valuation methodology based on industry standards and practice. This may be influenced by:

- The data available.
- The circumstances relating to the market.
- Industry practice and standards for the asset being valued.

5. International valuation standards recommend that valuers consider using more than one approach. For tax purposes, we recommend that (where possible) a secondary or cross-check methodology should be applied to provide additional support for an estimated value from the primary methodology.
6. The process of valuation requires the valuer to make impartial judgements as to the reliability of inputs and assumptions. For a valuation to be credible, it is important that those judgements are made in a way that promote transparency (for example, state the inputs and any assumptions made) and minimise the influence of any subjective factors on the process.
7. The valuer should assemble and record evidence by means such as inspection (as required), enquiry, computation and analysis to ensure that the valuation is properly supported.
8. An estimate provided for a future date (prospective value) is frequently sought in connection with projects that are proposed, under construction or under conversion to a new use. Market value for tax purposes requires valuation for a date specified by the legislation and a prospective assessment will not be considered reasonable or acceptable.

Essentially, to value your business you'll be required to adopt the correct approach and methodology, apply it correctly in accordance with professional standards, align it with the relevant tax laws and guidance, and ensure that all your workings, including the assumptions you've made and information and inputs you've used are correct, complete, and in a format that can be tested and replicated by the ATO's army of professional valuers.

In addition, the documents you're required to provide to demonstrate all this are extensive – we've included a full list from the guide at the end of this article. Needless to say, this is a complex process, and one that business owners who attempt to complete it themselves often get wrong.

So although the acceptability of a valuation usually depends on the process undertaken rather than who conducted it, it's not surprising that the Commissioner considers a valuation report, carried out by a suitably qualified professional following commonly accepted industry standards and professional codes of conduct, to be more reliable.

Ultimately, the guide notes that the onus for providing a replicable and defensible valuation remains with you even when a professional is engaged to provide the valuation.

What happens if the ATO thinks my valuation is wrong?

As part of its ordinary operations, the ATO may review your business or asset's market value relating to your tax affairs, with the likelihood of review higher where the methodology used is contentious or the value deviates too much from what would be expected by the market.

Where this is the case, you're expected to provide greater depth of evidence and explanation to support your valuation position. The guide notes that if you undertake your own valuation or use valuations from people without adequate qualifications, you risk incorrectly reporting your tax and may be liable to interest and penalties.

Where you underpay your tax, interest charges will apply. This may occur when a market valuation results in the market value of an asset or liability being over or undervalued. Additionally, the ATO is likely to apply administrative penalties, for example it determines you have been reckless in determining the value of the business. The amount of the penalty depends on the level of documentation and care taken but can be significant – up to 75 per cent or more of the tax that has been underpaid (in addition to paying the underpaid amount) and can be well in excess of having a qualified person provide an independent valuation to start with.

Documentary requirements for a valuation report

The ATO has outlined in the guide that it expects a valuation report to cover, at a minimum, the following information:

- The purpose of the valuation, including the tax and superannuation provision for which the valuation has been provided and any relevant legislative provisions, case law and ATO guidance considered.
- The scope of the valuation, including instructions and limitations on scope.
- Details of the asset being valued.
- Details of information (including its source and extent of investigation), facts, inputs and assumptions relied upon (including subject matter particulars and industry data).
- The standards governing the valuation engagement; for example, the IVS, APES 225 and RICS.
- The valuation assessment date; for example, a retrospective valuation assessment as at 1 July 2000.
- The date the valuer inspected the asset being valued (if applicable).
- The definition of value.
- Valuation approaches and methodologies chosen, including reasons for selection and any available cross-checks.
- Adequate records to explain the basis of the market value. These records should confirm that a valuation was undertaken and also contain sufficient detail to enable the valuation process to be replicated. Failure to maintain detailed reports and working papers may affect the credibility of the valuation and may not meet statutory record-keeping requirements. Where a valuation is straightforward or the asset's value can readily be determined objectively, the report and associated records may be brief.
- Expert reports (that have details similar to those required in valuation reports) and the use of experts. When relying on an expert in the valuation process, you should include sufficient detail to confirm the expert's:

o Competency in the field.

o Reasonable use of assumptions, methods and sources of data.

o Independence (or, if not independent, disclose the dependency and justification for it).

- The use of previous valuations, if applicable. If a valuer seeks to rely on a previous valuation, difficulties are likely to arise if the previous valuation was compiled for a different purpose. The current valuation should:

o Explain how the previous valuation is relevant to the current valuation, with a particular focus on the purpose of that valuation compared to the purpose of the current one.

o Confirm that the information and assumptions used in the previous valuation are still relevant.

o Declare how any adjustments and changes have been made to comply with any statutory requirements associated with the valuation.

- An explanation and quantifying of any material differences from values such as known historical costs, and values supported by previous valuations and valuations with a similar or proximate valuation date.
- Valuation conclusion that requires the specific market value be ascertained. Where the selected method leads to a range of possible values, an explanation is needed as to why the specific market value finally nominated was adopted.

- Any risks, disclaimers and indemnities. For instance, where a business valuation is dependent on the success of a commercial initiative by that business, these risks should be described in sufficient detail to show that they have been given due consideration and weight.
- Terms of engaging the valuer, including any special instructions relating to the valuation, whether in writing or verbal. In particular, the report should disclose any instructions that have affected, or are likely to affect, the valuation process.
- The valuer's identity, status and qualifications
- Declaration of independence and any conflicts of interest, including any relationship the valuer has with the client, in sufficient detail for us to assess the valuer's independence; and
- The date the report is issued.

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