Goodwill and the sale of business

So what and who cares?

Goodwill is a bit like the weather – as far as Mark Twain was concerned anyway. He said about the weather "Everyone talks about it but nobody does anything about it".

The High Court did something about goodwill 22 years ago in the *Murry case* and did something else about it just two years ago – in the *Placer case.*

Goodwill and its valuation are important. If you or a trust is selling a business, then you or the trust will typically be entitled to a 50% discount of the capital gain of that business attributable to goodwill by virtue of the provisions of Division 115 of the Income Tax Assessment Act 1997.

Goodwill and its valuation are also important for the purchaser of shares in a private company where the company is potentially "land rich". The value of goodwill will have a critical impact on whether stamp duty is payable on the purchase of the shares in such circumstances.

In the *Placer case*, the issue was: did the value of all of Placer's land, regardless of its location, represent 60% or more of the value of all of Places property?

So whether as a professional or as a business operator, it is important to understand goodwill because it can have a huge impact when it comes to maximising the net sale proceeds of the business which individuals and trusts will want to do when putting in place business succession and general estate planning strategies.

What this paper is about

In 1998 the High Court (in the *Murry Case*) put the definition of goodwill on the legal and accounting landscape. In 2018, the High Court (in the *Placer Case*) added some bells and whistles to that analysis.

The purpose of this paper is to consider the following:

(i) What is Goodwill?

(ii) Where does it come from?

(iii) How do you value it?

What is Goodwill?

Goodwill is easy to describe but difficult to define. It is a legal term, an accounting term and a business term.

Goodwill to accountants clearly means something different from what goodwill means to lawyers. There is no concept of negative goodwill in law. Goodwill for accounting purposes has been up to the present time essentially subjective, reflecting the excess that a purchaser is willing to pay for a business over the fair value of the identifiable assets acquired. In this sense, it has been essentially a balancing item.

Goodwill for legal purposes is property. It is the legal right to conduct a business in substantially the same manner and by substantially the same means *that have attracted custom to it in the past*. Goodwill is an intangible asset. It is forward looking. It has no existence independently of the conduct of the business and cannot be severed from the business which created it.

The courts will protect that property – those means of attracting custom to the business – irrespective of the profitability or value of the business, so far as it is legally possible to do so.

Sources of goodwill

The sources of goodwill include the use of tangible assets and intangible assets of the business. There are also other sources.

Examples are as follows:

- site goodwill – very important for the local grocer or newsagency,
- an enforceable restrictive covenant that retains customers or which reduces competition;
- statutory monopolies in respect of the business products such as trademarks or patents;
- personality of the business owner or key employees;
- service delivery – we all love attentive waiters and waitresses at a restaurant;
- price - an obvious matter;
- habit - "I have been using Colgate toothpaste since I was 12 years old".
- expenditures on advertising and promotion;
- funds expended on wages, customer services and labour (HR) relations;
- matters that are external to the business or its locality, such as imperfect competition or extensive market penetration.
- using its employees' skills to generate a reputation for reliability or service

What about the following? Are they sources of goodwill?

- Using employees with a proven capacity to develop and expand the business;
- Using a technically competent workforce;
- Using innovative business techniques which give the business efficiencies and economies of scale;
- Using special systems including strategic business plans.

The sources of goodwill can change over time.

Consider a local museum that was acquired sometime before the introduction of capital gains tax ('CGT') in 1985.

The museum derives some of its custom from:

- its expenditure on advertising & promotion;
- the sourcing of interesting and exclusive items for its exhibits;
- its locality being near a CBD and close to a number of high schools;
- its external structural appearance.

The museum attracts many school children on excursions but its trustees are disappointed that it does not attract more of the potential CBD patronage and so in 2005 the museum began to market on social media, focussing on the 18 – 35 age group demographic.

Now, the goodwill is no longer sourced from the first list of factors. Revenue has begun to rise to a level higher than it was prior to the commencement of the social media marketing campaign, and the sources of goodwill will now extend to the fact that the museum is now adopting social media and attracting custom from a new demographic.

Goodwill can be sourced from non-legal assets

For example, goodwill can be derived from the personality of the owner. On the owner ceasing connection with the business, goodwill may be expected to disappear to a large extent. However *habit* may continue to draw custom even though the former owner is no longer there. So goodwill can continue to exist notwithstanding the sources of the goodwill have changed.

When is goodwill acquired or created?

Goodwill can be acquired. It is acquired typically at the time of the contract for purchase of business – s 109.5 of the Income Tax Assessment Act 1997 (ITAA 97).

Goodwill can also be created. Section 109.10 of ITAA 1997 provides that goodwill is created when the work that resulted in the creation started. So in our museum example, additional goodwill began to be created when the social media marketing campaign began.

In *Murry*, a taxi licence was bought in 1987 for $85,000 and it was sold for almost double that amount 5 years later.

The High Court said that the taxi licence did not constitute a source of goodwill because it did not *attract custom*. It just authorised or permitted the lawful conduct of a taxi business.

The same analysis also applies where a dentist obtains their dental practising certificate, or where a person is issued with a licence to conduct a radio station or build a hotel. There is no goodwill until the dentist or station or hotel commences business.

The goodwill in the *Murry case* was not sourced in the taxi licence. The High Court said it was sourced in:

- the 'get-up' of the taxi;
- the advertising of the booking service; and
- the skill of the driver to find the best locations to find passengers, thereby attracting custom to the taxi business.

So some assets can be worth a lot. A taxi licence is one of them. A trade mark can be another. In such cases, the goodwill of the business is likely to be proportionately small.

But an exclusive licence is something else again. Consider an exclusive licence to conduct a particular business in a particular area – for example, the rights of a franchisee under a franchise agreement. You are the only Dominos Pizza franchisee in Cunnamulla. This means that the business has no competition in that area. That licence serves as a source of custom for the business.

When renewing a licence (whether it be for example, a taxi licence or a trade mark or a franchise), one might be entitled to roll-over relief under s 124 of the ITAA 1997. If available, this will ensure that the owner of the licence does not have to pay CGT every time they renew the licence and that a new asset is not created each time the licence is renewed.

But it is a mistake to say that goodwill for legal purposes includes everything that adds value to the business.

Some key assets do have in themselves power to draw custom – a trade mark is one such example. If such a trade mark is disposed of or is no longer connected with the business, then the transaction involving that asset is to be valued having regard to the earning power of the asset. But it does not involve the disposition of goodwill unless the sale of the asset is accompanied by or carries with it the right to conduct the business. Goodwill may continue in the business despite the sale of the trade mark for other reasons – *habit* for example.

Valuation of Goodwill

The conventional accounting approach to business valuations is to find the difference between the present value of the predicted earnings of the business (that is, the value of the business on a going concern basis) and the fair value of its identifiable assets. As I have mentioned above, in this sense, it has been essentially a balancing item.

As expressed by the majority in *Placer*, the legal view of goodwill is that it includes sources that generate earnings for a business by *attracting custom*, but does not extend to include every fact or matter that adds value to a business. Goodwill for legal purposes does not extend to every possible advantage and to whatever adds value. It does not necessarily extend to all the privileges or advantages that differentiate an established business from a business just starting out.

Once a business is operating, the business may develop certain advantages: the business might attract a regular clientele, it might enjoy a reputation for reliability or service, or it might employ highly skilled employees able to generate above – average earnings. These advantages will constitute goodwill *because they will generate custom greater than the industry average.*

This concept of "generating custom greater than the average", was referred to in the *Murry case* but *Placer* never explained what this meant. I suspect that it can be explained by reference to the fact that, as I say below, not all things which generate or add value or earnings to a business comprise goodwill.

If the business is selling goods and services which are virtually indistinguishable from others sold in that same market, above average earnings will be difficult to achieve. But if above – average earnings are achieved, it suggests the existence of goodwill; it suggests that the business is *attracting custom* greater than the industry average.

The measure of value of that goodwill is how much the earnings exceed the norm. That is, the business is getting more value out of the assets and its competitors because *the business is bringing in more custom.* It is not the same as going concern value, another concept or approach, which exists as an intangible separate from goodwill *even where there is no custom.*

In a profitable business, the value of goodwill for legal and accounting purposes will often, perhaps usually, be identical.

Where a business is trading at a loss, or with less than industry average profitability, there may be a marked difference between the value of goodwill for legal purposes and its value for accounting or commercial purposes. As a result, even when trading as a loss or just with low profitability, a business may have valuable goodwill in the eyes of the law although an accountant would conclude that the business either has no goodwill or that, if it has, it is of nominal value only.

Where a business is trading at a loss, there will be no gap between the value of predicted earnings and the fair value of the net assets. But the absence of a gap does not necessarily mean that there is no goodwill. For example, there may be goodwill derived from advertising in an unprofitable business.

The Bottom-up approach

Goodwill has historically (up to 2018) been determined by deducting from the present value of the predicted earnings of the business, the fair value of its identifiable net assets. This is called the ***bottom-up*** approach.

The Top-down approach

The *Placer case* involved an acquisition in 2006 by Barrick Gold Corporation ("Barrick") of all of the issued shares in Placer Dome Inc., which was a listed company with significant goldmining interests around the world, including in Western Australia. At issue was whether or not Barrick was exposed to ad valorem stamp duty on its share acquisition in Placer Dome. This liability ultimately depended on whether or not Placer Dome was a "land rich" landholder within the meaning of the *Stamp Act 1921* (WA). Whether it was "land rich" depended on the valuation of its goodwill.

In the *Placer case*, the court rejected the *bottom-up* approach and substituted for it, the *top-down* method.

This involved starting with the total value of all *Placer's* property and deducting the value of the non-land assets (including the goodwill) to get a residual value for the value of the land. However, the taxpayer – Barrick – used to the bottom- up approach. He relied on a discounted cash flow analysis that was predicated on various inputs (that is, he applied the going concern valuation and deducted the land value) and this left goodwill as a material residual figure. The

High Court upheld that the top-down approach was appropriate, and that *Placer* was a land-rich corporation.

In reviewing the amount allocated as goodwill, and the reasons for the allocation, the High Court confirmed that unless alleged sources of goodwill can *attract custom* to the business, they do not contribute to the generation of legal goodwill. However, they may contribute to the going concern value of the business.

The court clarified that goodwill for legal purposes extends to those sources which generate or add value (or earnings) to the business by *attracting custom*, whether that be from the use of identifiable assets, locations, people, efficiencies, systems, processes, or techniques of the business, or from some other identifiable source. And those sources of goodwill for legal purposes have a unified purpose and result – to generate or add value (or earnings) to the business by *attracting custom*.

If there are above average earnings, the business is getting more value out of the assets than its competitors because the business is *bringing in more custom*. However, that is not the same as a going concern value. The concept of going concern exists as an intangible separate from goodwill even where there is no custom.

Goodwill for legal purposes is different from and is not to be confused with the "going value" or the “going concern value” of the business. The going concern value of the business reflects the ability of that business to generate income without interruption even where there has been a change in ownership. It is different from the concept of goodwill. Goodwill value reflects the right to conduct the business by means which have attracted custom to the business.

A going-concern business has a value over and above the aggregate value of the tangible property employed in it and such excessive value is nothing more than the recognition that, used in an established business that has won the favourite of its customers, tangibles may be expected to earn in the future as they have in the past. In short, the owner of a going concern business enjoys two privileges stemming from ownership – the privilege of continuing to use the assets to generate income and the privilege of continuing to deal with the customers. The latter is goodwill. The latter (goodwill) depends on the former.

Alleged sources of goodwill in Placer included the items listed below. The court said that these items have to be considered in terms as to whether they generate or add value or earnings to the business *by attracting custom*. If they do then they are thereby comprised in the concept of goodwill for legal purposes.

As it turned out, Barrick in the *Placer case* could not establish that any of the "sources" could generate or add value (or earnings) *by attracting custom* to Placer's business.

- Employees of Placer said to have proven capacity to develop and expand the business. The court said that this was implausible in face of evidence that the major driver of the acquisition was the streamlining of operations of the amalgamated entity which meant redundancies and office closures.
- The technical capacity of the personnel. The court said that the capacity to develop innovative mining techniques did not attract custom of any material value. In any event, the WA Stamp Act required "…knowledge or information that has commercial value relating to…process[es]…to… extract… minerals" – that is, the technical capacity of the employees – to be precluded from the valuation.
- Innovative mining techniques which were said to have enabled Placer to extract lower grade ores giving it a competitive advantage over other miners. The court said that these were also to be discounted because the provisions of the WA Stamp Act required that they be discounted.
- The experienced project group and mine managers. The court said that there was nothing to suggest that Placer's personnel had any unique expertise or ability. The evidence was that another mining company could have competently operated the mine.
- The size, structures and systems that enable Placer to harvest economies of scale. The court said that it was unclear how size alone could be a source of goodwill. The other elements were also discounted.

- The synergies. The court said that the synergies of combining the scale, structure and features of Placer's business were merely cost savings and not a source of Placer's goodwill. In any event, the synergies arose on or after amalgamation; they were a reason for the amalgamation. The synergies did not exist without the purchase. The synergies were not part of Placer's property.

These may have contributed to going concern value, but going concern value is not the same as goodwill value. The going concern value treats goodwill, if it exists, as no more than a component of the going concern value. The two concepts are not synonymous and should not be confused with each other.

As we have seen, goodwill has sources, not elements, and the sources of goodwill for legal purposes are those which generate real value (or earnings) to the business by *attracting custom.*

Placer emphasised the need to consider the intrinsic ability of a business to create excess or at least above-average earnings during the course of assessing its goodwill value.

Where to from here?

Some of the practical implications of this legal analysis include:

- It might be said that the precedent value for *Placer* is limited to the interpretation of the landholder provisions of the WA Stamp Act. However, the High Court in *Placer* did say that a valuation must take into account and be consistent with the relevant statutory framework for which the valuation is required. For example, in Placer, the WA Stamp Act set out a number of restrictions which had to be adopted in determining the land value. I have mentioned a couple of them above.
- Implications from this include that taxpayers and their advisers, should work with valuation experts to ensure that the valuer has appropriate regard to the relevant statutory context. This could mean that multiple valuation reports are required depending on the purpose for which they are to be used.

- Legal goodwill might be harder to establish for a business that is selling goods and services that are virtually indistinguishable from others sold in the same market. Where such a business achieves earnings above the industry average, this could support the existence of valuable legal goodwill, but it will be necessary to establish that the increased earnings arise from the attraction of *additional custom* rather than some other aspect of the operations.

Some of the key areas in which we expect taxpayers and revenue authorities to seek to apply *Placer* principles include:

- The ITAA 97 Division 152 Small business CGT concessions, and the definition of 'active asset' under these concessions. Of particular relevance, is the 'CGT Participation Exemption' and the calculation of the value of 'goodwill', which would be an 'active asset' for the purposes of this calculation.
- Asset sale and purchases where there is no purchase price allocation contained in the transaction documentation and it is necessary for taxpayers to apportion the purchase price to depreciation assets or to capital gains tax assets;

There are many others including:

- Tax consolidation issues;
- The principal asset test contained in the non-resident CGT rules;
- The calculation of maximum allowable debt under the 'thin capitalisation' provisions of the ITAA 97.

and your accountant will be able to explain these items in the appropriate detail.

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