Chapter 4

DETERMINING THE APPROPRIATE TREATMENT OF GOODWILL

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Key considerations

What is 'goodwill'?

4.1 For accounting purposes goodwill is defined in Australian Accounting Standard AASB 1013 *Accounting for Goodwill* as 'the future benefits from unidentifiable assets. Unidentifiable assets are those assets that are not capable of being both individually identified and specifically recognised.'

- The commentary to the standard indicates that examples of unidentifiable assets include market penetration, effective advertising, good labour relations and a superior operating team. Unidentifiable assets do not include assets that are intangible but are capable of being individually and separately recognised (for example, patents, licences, rights and copyright).

4.2 The income tax law does not specifically define goodwill. However, in the leading case of *IRC v Muller & Co's Margarine Ltd* [1901] AC 217 at 223-4, Lord McNaughton described goodwill as follows:

> 'What is goodwill? It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old established business from a new business at its first start.'

4.3 The accounting and legal concepts of goodwill, therefore, differ significantly in practical terms. The accounting and economic concepts of goodwill, on which tax could be based, are logically similar.

How is goodwill taxed at present?

4.4 Goodwill is generated by the activities of a business in establishing and maintaining a clientele. It is built up by advertising, through customer service and good business practice. The expenses incurred in building up goodwill are typically immediately deductible.

4.5 Of course the value of goodwill associated with a business can change for a wide variety of reasons and the change is, in many cases, outside the control of the business. For example, a competitor opening a business nearby can impact on the value of goodwill associated with the existing business.

4.6 Under current law, acquired goodwill is taxed under the capital gains tax (CGT) provisions — that is, to the vendor, the proceeds are taxed as capital income and to the acquirer, the consideration forms the cost base. There are no provisions to allow taxpayers to deduct or amortise the cost of acquired goodwill. Thus if acquired goodwill is subsequently disposed of, the capital gain or loss is brought to tax in accordance with the CGT provisions.

4.7 For businesses with net assets of less than $2.2 million, 50 per cent of the value of goodwill disposed of is exempt from CGT. Particular issues that arise with respect to the operation of the CGT goodwill exemption for small businesses are discussed in Chapter 11.

4.8 It is argued that as the acquisition of goodwill is a legitimate expense incurred in the acquisition of a business, it should be able to be written off for tax purposes in the same way as acquired plant and equipment.

How do other countries treat goodwill?

4.9 The international treatment of goodwill is set out on pages 74 and 75 of *An International Perspective*. In half of the jurisdictions surveyed, acquired goodwill is not deductible. Other countries, including the US, allow amortisation over periods ranging from 5 to 20 years.

Policy issues

Valuation of goodwill

4.10 Given that expenses incurred to build up goodwill would continue to be immediately allowable as deductions, a matching treatment of income would require that the annual increases in goodwill would be taxed. However, as goodwill (however defined) can only be accurately valued upon realisation, such an approach to taxation of goodwill would not appear to be a practical proposition.

4.11 Acquired goodwill is normally purchased along with other assets (both tangible and intangible) of a business. As goodwill has no precise meaning, its acquisition cost may simply be a residual amount payable, consistent with the accounting treatment, after precise values have been allocated to other assets.

4.12 Experience with the CGT goodwill provisions suggests that there are significant practical difficulties in ascribing valuations to goodwill in particular cases; so much so, that cases have been litigated as far as the full

bench of the High Court. These difficulties arise because vendors have sought to maximise the tax benefits associated with the CGT goodwill exemption by reducing the values of other business assets. It would be reasonable to conclude that were acquired goodwill accorded taxation amortisation, tax planners could be tempted to shift value away from less tax preferred assets into goodwill.

Is goodwill a wasting asset?

4.13 Unless a person who acquires an existing business maintains the same levels of customer service, and so on, the goodwill of the business will inevitably decline. Given that expenditures required to maintain goodwill are typically immediately deductible then deductions for expenditure sufficient to maintain the level of goodwill are equivalent to allowing write-off. That can be demonstrated by Example 4.1.

Example 4.1: Taxation of goodwill

Goodwill is purchased for $1,000 and in the absence of any expenditure would decline in value to $800 after one year. If goodwill were to be amortised on an accruals basis, the taxpayer would be entitled to a deduction of $200.

However, if the taxpayer spent $200 to return the value of goodwill to $1,000 the current law would allow a $200 deduction. This is an appropriate outcome since the taxpayer still has goodwill valued at $1,000 and is only $200 worse off by virtue of his or her expenditure on maintaining that goodwill.

If the taxpayer spent $300 to increase the value of goodwill to $1,100 he or she would be allowed deductions of $300 under the current system but not be taxed on the extra $100 of goodwill until it was sold. While this illustrates the tax deferral that would arise, it would be impossible to separate this type of situation from the case where the expenditure involved did nothing more than maintain the value of goodwill.

If the value of goodwill changes for reasons totally outside the control of the taxpayer, the current treatment does not recognise this change in value until it is realised.

4.14 The example demonstrates the following points:

- taxpayers are effectively getting immediate deductibility for expenditure in building up goodwill over and beyond the original cost; and
- when created goodwill has been sold the seller has already received full deductibility for any costs incurred in creating that goodwill
  - if the seller is then taxed on the full value as a capital gain, he or she would have still benefited to the extent of the tax deferral.

Policy options

Option 1: Allow acquired goodwill to be depreciated

4.15 Option 1 would allow acquired goodwill to be depreciated but on the further sale of the business the total goodwill less any undeducted acquired goodwill would be subject to tax. This approach, over time, would bring to tax the same amount of goodwill as the current system, but it would involve a much greater degree of tax deferral.

Option 2: Retain the current treatment

4.16 At present, the value of acquired goodwill is effectively deducted at the time of the further sale of the business since it is the cost base for goodwill being sold — leaving aside the effects of indexation. If acquired goodwill were allowed to be depreciated, it would be deductible much earlier while created goodwill would still only be taxed on realisation.

4.17 Where the goodwill associated with a business is increasing in value it can be argued that the current treatment is appropriate, taking into account the practicalities of valuing goodwill. Of course, in some cases the goodwill associated with a business will decline — for example, traffic might be diverted around a previously busy spot where a service station was located. In such circumstances, there would be a case for a deduction at the time that loss in goodwill occurred. However, if losses relating to goodwill were recognised as they accrued, then symmetry would require that gains also be taxed on accrual.

Accounting treatment

4.18 Under the AASB 1013 *Accounting for Goodwill* issued in June 1996, purchased goodwill must be amortised on a straight-line basis, over the period during which the benefits are expected to arise. This period must not exceed twenty years from the date of acquisition.

4.19 The reasons for amortising goodwill for accounting purposes are consistent with a prudent approach to financial reporting. The standard recognises that certain elements contributing to the future income flows of a business that are captured in acquired goodwill may have a finite life. Such elements include service life of employees, expected actions of competitors and relevant legal and contractual provisions.

4.20 The tax arguments for not allowing a deduction by amortising acquired goodwill are that this would involve recognising the losses involved as they accrue but not taxing gains until realisation. These concerns are not of such importance in an accounting context.

Revenue implications

4.21 The revenue implications of providing a taxation write-off for acquired goodwill could be significant but the nature of the measure is such that reliable estimates would be virtually impossible to make. No data are available on the amount of goodwill purchased.