Goodwill: leaving its mark across duty and income tax legislation

13 December 2018

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In brief

The Commissioner of State Revenue WA (**Commissioner**) was successful in her appeal to the High Court of Australia (**HCA**). The decision, *Commissioner of State Revenue v Placer Dome Inc* [2018] HCA 59, considers the nature of legal form goodwill, and whether certain valuation methodologies are appropriate in ascertaining the value of "land".

The decision has implications across a wide range of statutory contexts including both income tax provisions and other States' landholder provisions. Accordingly, a careful understanding of the case is necessary for all taxpayers who have to document valuation outcomes to discharge obligations under taxation statutes.

The decision turned on the outcomes from the valuation methodologies adopted by the parties – in particular, whether the company acquired had any goodwill of material value. The Commissioner contended that a "top-down" valuation method should be adopted attributing any residual value to land, while the taxpayer relied on a discounted cash flow (**DCF**) analysis predicated on various inputs which left goodwill as a (material) residual figure.

In detail

The High Court handed down its decision on 5 December 2018 which addressed the imposition of WA land rich duty in respect of the acquisition of Placer Dome Inc. (**Placer**) in 2006.

The statutory context was critical to the dispute, and broadly required the parties to determine whether the value of all 'land' to which Placer was entitled was 60 per cent or more of the value of all property to which it was entitled. Any value ascribed to goodwill was pivotal in determining whether this ratio was breached.

The Commissioner was appealing from a decision of the WA Court of Appeal which held that a gold mining company could possess goodwill of material value.

Valuation authorities

When applying the relevant valuation principles, the HCA noted it is important to identify the purpose of the valuation exercise. As part of this, the HCA highlighted that *Spencer's case* [1]is a compensation case

[1]*Spencer v The Commonwealth* [1907] HCA 82.

not a revenue case but acknowledged that some of the principles are still appropriately applied in other contexts

Taxpayers should test and distinguish the application of valuation authorities to their particular circumstances. This case as well as the recent *Resource Capital Fund* [2]decision, demonstrate how important the appropriate briefing of expert valuers is in revenue matters. Taxpayers, and their advisers, should work with valuation experts to ensure that the valuer has appropriate regard to the relevant statutory context and judicial precedent.

This may mean that multiple valuation reports are required depending on the purpose for which they are used; a valuation carried out for accounting purchase price allocation may not automatically be appropriate for landholder duty filings, and a landholder duty valuation may not automatically be appropriate for tax consolidation purposes.

Valuation methodology

The HCA held a valuation must take into account, and be consistent with, the relevant statutory framework. The HCA found there are risks inherent in a DCF analysis and reliance on certain inputs can lead to error. If there is a gap in the DCF analysis, the gap must be capable of explanation[3].

The HCA held the DCF analysis led to a goodwill allocation that "*included a value reflecting the expectation of these future events, which events did not exist prior to the acquisition date. Critically, there was a value in the goodwill allocation that was not value which inhered in Placer*[4]*".*

The taxpayer's reliance on the residual value being allocated to goodwill was not accepted for various reasons, including:

- the taxpayer did not possess AUD 6 billion of legal goodwill; and
- a number of "*sources*" of goodwill were either (i) excluded by the statute (which had provisions specifically dealing with existing knowledge and intellectual property); (ii) had no material value in isolation; or (iii) had no material value separate to the land.

The decision also highlights the importance of supporting evidence in revenue cases particularly when it comes to valuation matters.

Goodwill

This decision will now be the leading judicial precedent on the legal nature of goodwill - expanding upon, and clarifying *Murry's case* [5]which was the previous leading authority. The structure of the judgment is helpful in clearly setting out:

- the *nature* of goodwill and the HCA's view that the *attraction of custom* is central to goodwill as a concept [see [12]-[22]];
- to be property (important for this statutory context) *goodwill* must be comprised of those rights or privileges that preserve the custom attracted to that business [see [19], [23]];
- the *sources* of goodwill must have a unified purposes and generate or add value or earnings to the business by attracting custom [see [24]-[47]];

[2] *Resource Capital Fund IV LP v Commissioner of Taxation* [2018] FCA 41.
[3] at para 48.
[4] at para 41.
[5] *Federal Commissioner of Taxation v Murry* (1998) 193 CLR 506.

- the *value* of goodwill can be determined by reference to *'the difference between the present value of the predicted earnings of the business and the fair value of its identifiable net assets"* but **cannot** be the *"fair value of Placer's identifiable net assets [compared] to the purchase price of the business"*;[6] and
- the HCA did not accept the broader "added value" approach to determining goodwill in reinforcing the primacy of the "added custom" approach.

Some of the practical implications of the above legal analysis could be:

1. Adopting an accounting treatment (such as in the purchase price allocation report) is not automatically appropriate for allocating an objective value for goodwill.

2. Context may alter the concept of goodwill depending on the circumstances. Interestingly, the HCA notes that "*courts define, and identify, goodwill in differing factual and legal contexts. The definition in one context is more often than not inappropriate in another context*."[7] Namely, the particular factual and legal context is critical to the existence of goodwill.

3. *Murry* must be read in its entirety rather than *"taking a few isolated passages out of their context"*.[8] The HCA clarified the application of *Murry's case*[9] – namely that goodwill for legal purposes comprises sources which generate earnings for a business by attracting custom. Importantly, "custom" remains central to the concept of legal goodwill.

4. Separate sources of goodwill will need to be identified by taxpayers separate to the portfolio of land assets. The HCA cautioned against "*attributing a value to goodwill which actually inhered in an asset which was a source of goodwill*".[10] The HCA held that in the circumstances it could not be demonstrated that the various sources existed or that the sources could generate earnings by attracting custom. This reinforces the importance of appropriately instructed expert valuers.

5. In a landholder context, synergies cannot inform the value of goodwill. This is because "synergies" were not property of Placer Dome Inc. at the time of acquisition – rather, the synergies were an asset of the amalgamated entity. Therefore, any cost savings to be derived by an acquisition are not classified as goodwill.

6. Goodwill for Australian purposes may differ from its definition in other jurisdictions. The HCA declined to follow the lead of other jurisdictions in recognising "*going concern*" value as a separate proprietary right. This is because of the conclusion that the value of goodwill must be determined by reference to the nature of goodwill as being the attractive force which brings in custom. The HCA rejected the concepts of "*added value*" goodwill or "*going concern*" goodwill, as "*goodwill at law does not extend to include every fact or matter that adds value to a business*".[11]

7. Legal goodwill may be harder to establish for a business that is selling goods and services that are virtually indistinguishable from others sold in the same market.[12] Where such a business achieves earnings above the industry average, this may support the existence of valuable legal goodwill but

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[6] at para 78.
[7] at para 55.
[8] at para 65.
[9] *Federal Commissioner of Taxation v Murry* [1998] HCA 42.
[10] at para 83.
[11] at para 89.
[12] at para 84.

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.

Application beyond duty - potential relevance to taxation matters

At face value, the precedential value of the *Placer* decision is limited to the interpretation of the landholder provisions of the WA Stamp Act, however as a broad exposition of the nature, source and value of goodwill, the case will be relevant to a broad range of revenue matters.

Some of the key contexts where we expect taxpayers and revenue authorities to seek to apply *Placer* principles include:

1. Tax consolidation and the tax cost re-setting process and in particular the allocation of allocable cost amount to reset tax cost assets on entry (and the potential application of capital gains tax (CGT) event L4) and the calculation of exit allocable cost amount on exit;

2. 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 capital gains tax assets;

3. The principal asset test contained in the non-resident CGT rules. In this case, *Resource Capital Fund*[13] will also be relevant. The *Placer* judgement will likely influence the calculation of goodwill which would be a non-land asset within these provisions;

4. The CGT participation exemption and, in particular, the calculation of the value of 'goodwill' which would be an 'active asset' for the purposes of this calculation;

5. Applying the business related capital expenditure (or 'blackhole) provisions and, in particular, the application of the "exception to the exception" most recently considered in *Sharpcan*;[14]

6. The calculation of maximum allowable debt under the thin capitalisation provisions having regard to the modifications that can be made to the accounting values in certain circumstances; and

7. Small business CGT relief and the definition of active asset under these provisions.

The wide-ranging nature of these statutory provisions and the different statutory contexts in which the concept of goodwill is used in each of these provisions means that care must be taken in automatically relying on *Placer* (just as the majority cautioned against the inappropriate invocation of *Murry*).

However, at its simplest, *Placer* stands for the proposition that the statutory context must inform any valuation undertaken for revenue purposes, and the valuation methodology must appropriately reflect that context.

It is also now the leading precedential authority in respect of the nature, sources and value of goodwill (at least the legal concept of goodwill). In this respect, taxpayers grappling with any of the statutory issues outlined above should have regard to *Placer* and the principles outlined therein.

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[13] *Resource Capital Fund IV LP v Commissioner of Taxation* [2018] FCA 41.
[14] *Commissioner of Taxation v Sharpcan Pty Ltd* [2018] FCAFC 163.

While providing extensive guidance as to what may constitute goodwill, arguably the HCA left open the possibility that operating businesses, including mines, may have other valuable intangible property. In some cases, these intangible assets may need to be identified as property at law as distinct from an accounting asset. In other cases, if they can be identified for accounting purposes this may be sufficient. In either case the valuation of these assets will be important.

The takeaway

Valuation exercises must be undertaken in the legal and factual context in which they arise. Taxpayers must be able to accurately document the sources of goodwill particular to their business, and ensure the adopted valuation methodology is fit for the statutory purpose.

In most revenue contexts (both income tax and stamp duty), taxpayers bear the onus in demonstrating that assessments are invalid or incorrect, and should test the strength of their documentation and evidence at the time of the transaction.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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