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# ***Rigour required to ensure valuations are fit for purpose***

21 September 2017

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## ***In brief***

The decision handed down by the Supreme Court of Western Australia (the Court) in *Placer Dome Inc vs Commissioner of State Revenue [2017] WASCA 165* on 11 September 2017 provides valuable insight into how the judiciary is likely to approach the assessment of competing valuations in a mining context. The case provides some interesting commentary on the identification and valuation of goodwill, particularly for mining companies.

The decision has potential relevance to a wide variety of tax topics, including stamp duty, thin capitalisation, tax consolidation, capital gains tax and tax effect accounting.

In arriving at its decision, the Court made a number of observations that taxpayers and valuers should consider as part of assessing their approach to undertaking valuations, including:

- In the circumstances, a top-down valuation approach (i.e. valuing land as being equal to the residual value remaining after deducting the value of other identifiable assets from the enterprise value) was not appropriate.
- The discounted cash flow (DCF) methodology tends to overstate the value of land, as it values an operating business and not just the land.
- The concept of 'goodwill' extends beyond the attraction of custom, and extends to every positive advantage enjoyed by a business.
- There was evidence that Placer Dome Inc (PDI), a large global gold mining company, may have substantial goodwill.

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## ***In detail***

### ***Transaction and legislative context***

In 2006, Barrick Gold Corporation (Barrick) acquired a controlling in PDI, which had significant gold mining interests around the world. The Commissioner of State Revenue (the Commissioner) assessed Barrick to duty on the basis the company had triggered the listed land-rich regime under the *Stamp Act*

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1921 (WA). The land-rich regime has since been replaced by the landholder regime across Australia, but the land valuation principles remain applicable.

The statutory context was critical to the dispute, and broadly required the parties to determine whether the value of all land to which PDI was entitled (regardless of where it was located) was 60 per cent or more of the value of all property to which it was entitled (other than excluded property).

The Commissioner found the ratio test had been satisfied, and the value of PDI's interests in land in Western Australia was approximately \$1 billion. The resulting duty exposure was \$54,852,300.

### ***The Decision***

At first instance, the State Administrative Tribunal (SAT) favoured the valuation evidence led by the Commissioner, which employed a DCF analysis predicated on the future price of gold assessed by reference to gold futures contracts, with an increasing adjustment for future years where no gold futures contract prices were available. The evidence favoured by the SAT indicated:

- a 'top-down' approach to valuing land was appropriate in the circumstances; and
- the market value of PDI's goodwill was 'highly unlikely to be significant' as it was 'intuitively improbable that a commodity producer of a homogeneous product would have any material goodwill value'.

In allowing the appeal, the Court found the SAT:

- failed to distinguish between the value of land and the value of the business conducted using that land; and
- erred in accepting the valuation evidence adduced by the Commissioner (dismissing the use of gold futures contracts in the valuation of a gold mining business and the assumption that the goodwill of a gold mining company would be insignificant).

The Court was critical of the valuation methodology employed by the Commissioner, but did not specifically approve the valuation methodology employed by Barrick's experts. Rather, the assessment as to the value of PDI's land (including land in Western Australia) was returned to the SAT, but made subject to a number of defined parameters, including:

- a top-down valuation approach was not to be applied; and
- the evidence to be considered was to be limited to, amongst other things, considering the value of land implied by the DCF applying to PDI's operations, adjusted for the fact that the DCF inherently valued the mining operations as a going concern rather than on an individual asset basis.

### ***Reasoning behind the decision***

#### *The correct valuation methodology turns on the circumstances*

The SAT found the statutory question could be answered by subtracting the value of all non-land assets (essentially goodwill) from the total consideration paid to acquire the shares of PDI (the 'top-down' valuation methodology). The Commissioner used this methodology to value PDI's business (i.e. operating mines) and some of the attending components, finding that there was no material goodwill in the PDI business.

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However, the Court found that a 'top-down' approach should only be applied if the individual assets comprising the total assets of the relevant corporation, and the value properly applied to each of those individual assets, can be ascertained with certainty. Where this is not the case, the approach of valuing the land at a residual value after deducting the value of other identifiable assets was considered likely to overstate the value of land, particularly as it could fail to properly distinguish between the value of the land and the value of the business conducted on that land.

The Court found, in the circumstances, the task ought to have been approached by separately assessing the value of the land in accordance with the principles established in *Spencer v the Commonwealth* [1907] HCA 82. The Court noted that the use of DCF methodology to assess the value of the land would tend to 'overstate the price at which the land would have sold, because the methodology values an operating business and not just the land'.

In allowing the appeal, the Court did not, by inference, accept the valuation evidence submitted by the Appellant at the original SAT. In fact, it observed:

*"To the contrary, it appears to be plausible, as submitted by the Commissioner, that the proposition that the total value of all PDI's land assets, being its extensive mining operations across various continents, represent only a little over one-third of the value of all its property, and is approximately equal to, or even a little less than, the value of unidentifiable or intangible property such as goodwill is, on its face, a surprising proposition which should be subjected to detailed scrutiny."*

#### *Goodwill may exist in resources companies*

The Court considered the issue of goodwill as it may apply to resource companies, and was highly critical of the narrow view of goodwill taken by the SAT.

The Court found that the SAT had misconstrued the decision in *Federal Commissioner of Taxation v Murry* [1998] HCA 42. The SAT had concluded that there was no evidence to support the submission that PDI's business included a substantial amount of goodwill. The Court found that the SAT's conclusion was 'clearly wrong' and further that 'there was ample evidence of the intangible aspects of PDI's very substantial business which contributed to its profitability'.

Reference was made to factors that might explain the existence of goodwill, including:

- A significant workforce (more than 13,000) which brought specific skills and expertise.
- Management systems and structures, including the capacity to develop and expand the business through a programme of exploration, the application of the technical capability of its personnel and its global operating structure.
- innovative mining techniques developed from its own mining laboratory.

The Court also criticised the SAT, finding that synergies arising from the acquisition of PDI's business could not be regarded as an asset of PDI. The Court stated that this erroneously confused '*the sources of goodwill, and its valuation, and the goodwill itself*'.

Murphy JA provided some additional observations on the topic of goodwill including:

*"In the case of a business selling goods or services which are virtually indistinguishable from the goods or services of others in the same market, the creation or maintenance of goodwill of any material value will generally depend upon any special advantages enjoyed by the business over its competitors which enable it to achieve above average industry custom or earnings."*

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*“In the end, the value of goodwill for legal purposes, but not its existence, is governed by the extent to which the earnings of a business exceeds the norm. In other words, as I would apprehend it, where the ‘focus of the inquiry’ is the value of the goodwill of a business, value will ordinarily be assessed in the context of the industry in which it operates and with regard to whether its earnings exceed those ordinarily enjoyed in the industry. Where the purpose of the inquiry is to ascertain the value to be attributed to the goodwill of the business, evidence of average or below average earnings will militate against acceptance that it has goodwill of any material value.”*

In light of the above, it will be important for taxpayers to evaluate whether their business has significant intangible assets, including goodwill, and to correctly attribute value to the intangible assets.

*Valuations must be predicated on correct inputs*

The differences between the valuation evidence led by Barrick and by the Commissioner were largely explained by the difference in gold prices which were used by the respective valuers. The Commissioner’s valuer favoured the use of gold futures prices.

The Court cited various reasons why gold futures prices are not appropriate for valuing a gold mining business, including that the gold futures market is thin, illiquid, opaque and of limited duration. The limited horizon necessitated the commercially unrealistic assumption of ever-increasing gold prices by the Commissioner’s valuer.

The Court found that the SAT had not taken into account the limiting factors of the valuation methodology employed by the Commissioner. Therefore, it is critical for taxpayers to scrutinise the inputs and assumptions that underpin their valuations.

The Court refused to quash the assessment issued to Barrick due to the absence of findings by the SAT on the valuation evidence adduced by PDI. As the matter has been remitted to the SAT to be determined in accordance with the Court’s parameters, we await a definitive outcome on the correct valuation methodology to be employed.

### ***The takeaways***

The decision illustrates several important issues for taxpayers (particularly in the resources industry):

- The importance of robust valuation evidence fit for the statutory context.
- It cannot simply be assumed that mining operations will not have material goodwill value.
- The challenges implicit in valuing intangible assets of a business.
- The framing of instructions to valuers.
- Consideration of the inputs and assumptions that frame a valuation report.

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### ***Let's talk***

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

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