Recognising the cost of purchased goodwill

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Abstract

The nature of "goodwill" for tax purposes was an important issue in Australia long before the adoption of the Commonwealth income tax, with the relationship between goodwill and sales of business premises a central issue in colonial stamp duty assessments (and consequent litigation). Judicial precedents and doctrines were transferred into the income tax arena as a result of a provision in the first Commonwealth income tax law that allowed depreciation of goodwill associated with leasehold interests. Judicial views were subsequently refined when the nature of goodwill was considered in the context of small business concessions for gains on the disposal of goodwill and in an important case in which a vendor created a notional goodwill asset in the course of a financial arrangement. Importantly, since 1964, Australian taxpayers have not been able to depreciate the cost of any form of purchased wasting goodwill. The Australian tax position stands in contrast with that of the UK, Canada, the US and many other countries. This article reviews the concept of goodwill in Australian tax law and suggests allowance of depreciation of purchased goodwill would be a logical reform to make, contributing to better alignment of the law with benchmark income tax principles.

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1 Introduction

After a century of jurisprudence and inconsistent statutory treatment, an accepted understanding of the concept of goodwill for income tax purposes remains elusive in Australia.[1] A feature of tax reform initiatives in many jurisdictions abroad has been the recognition of purchased goodwill as a limited life wasting asset, with the cost of acquisition recognised by means of annual depreciation (variously called depreciation, amortisation and capital cost allowance) deductions. Australia, in contrast, increasingly sits as an outlier, treating purchased goodwill as a non-wasting capital asset, with the cost of acquisition recognised as a cost base in the event of a future disposal of the asset. The last serious consideration in Australia of the soundness of the Australian rule was carried out almost two decades ago, when the analysis was seriously muddied by a focus on concessional treatment for vendors of goodwill, with the denial of cost recognition for purchasers likely perceived by the designers as a trade-off for provision of the concession for vendors.

A factor contributing to the lack of reform in Australia may be confusion among policy makers as to the nature of goodwill. Seeking tax advantages, taxpayers have attempted to label a wide array of arrangements and assets as "goodwill", with most enjoying at best a tenuous connection with genuine purchased goodwill, the value of a going concern exceeding the value of separate assets used in the business. A helpful starting point for a consideration of the appropriate treatment of the cost of purchased goodwill for income tax purposes is earlier tax jurisprudence for illustrations of the types of benefits transferred with a business that vendors or purchasers have described as goodwill. An appropriate system to recognise the cost of acquiring purchased goodwill can only be designed after the asset is extracted from the confusing pool of benefits mislabelled goodwill.

Section 2 of this article briefly explains why, in the context of the general distinction in Australian income tax law between revenue and capital expenses and the rules for recognising the cost of intangible benefits, deductions for depreciation have not been available in tax law for the cost of purchased goodwill, a benefit with a limited but indeterminate life. Sections 3 and 4 then review, respectively, the history of the goodwill concept in stamp duty and the four areas of income tax that have involved claimed transfers of goodwill. Section 5 notes how key jurisdictions abroad recognise the cost of purchased goodwill and section 6 sets out a design for tax recognition of the cost of purchased goodwill that better aligns with benchmark income tax principles. Section 7 concludes.

2 Why isn't goodwill depreciable?

Judicial decisions on goodwill have consistently stated that goodwill is an asset separate from the business with which it is associated but at the same time is also inexorably tied to that business so it can never be severed and sold separately.[2] Drawing on UK stamp duty precedents, courts initially described goodwill in terms of two business attributes that could not be sold *with* a business: personal goodwill attributable to a business owner's personal

1 See Pagone J in ***Uniqema Pty Ltd v Commissioner of State Revenue*** [2002] VSC 157; 50 ATR 91 at [20]. See further, G T Pagone, "Goodwill and its relationship to land" (11th Annual States' Taxation Conference Paper, Taxation Institute of Australia (Melbourne), 29 July 2011).

2 The High Court explained in ***FCT v Murry*** (1998) 193 CLR 605; [1998] HCA 42, at para 36 that two fundamental premises of the law of goodwill were "that goodwill has no existence independently of the conduct of a business and that goodwill cannot be severed from the business which created it."

qualities that attracted custom, and locational goodwill, attributable to the address of the business. The former necessarily remains with the vendor when a business is sold[3] and the latter is not transferred but rather is a misstated description of the significance of location to the value of the real property interest transferred with a business. In more recent case law, courts have described goodwill in terms that accord with its actual commercial nature, that is, value added by business synergies and existing custom – the operational systems already in place that generate higher returns and the existing clientele likely to continue to frequent the business.[4]

Goodwill has a limited life. Synergies recede as the business continually adopts new business processes and structures as the economy and commercial practices evolve and existing customers move, die and change tastes. Nevertheless, the Australian federal income tax law, when first adopted in 1915, provided no recognition for the cost of goodwill or that of any other wasting intangible asset. Deductions were allowed only for costs that could be characterised as revenue outgoings under the judicial tests used to distinguish revenue and capital expenses. The Act denied deductions for all capital expenditure unless specifically allowed[5] and the depreciation rule that acted as an exception to the general rule only applied to chattels or tangible movable property.[6]

Later, the depreciation rules for wasting assets were expanded to include tangible assets (including buildings) used in the farming, mining, fishing and forestry industries, and subsequently buildings used as hotels and motels and later still other buildings used to derive assessable income. Separately, specific depreciation provisions were added for registered intellectual property, other than trademarks, and later a five-year straight-line depreciation rule was adopted for all other capital expenses not otherwise recognised for tax purposes that had been incurred to derive assessable income but which were not incurred in the acquisition of any tangible or intangible asset.[7]

In general, the only cost recognition avenue open to taxpayers acquiring intangible assets with known limited multi-year lives such as contractual rights or non-competition agreements or assets with limited, but less certain, lives such as goodwill was found in

3 Hill J explained in *FCT v Krakos Investments Pty Ltd* (1995) 61 FCR 489 at 497, 96 ATC 4063 at 4069 that personal goodwill was "incapable by its very nature of being directly assigned to another, although it may be availed of by another securing the services of the person to whom the goodwill attaches and perhaps by that person agreeing not to work for another or in competition". See further Campbell Rankine, "Revenue law implications of intangibles: goodwill", Taxation Institute of Australia SA Division conference papers (2005), at 3.2.1, arguing personal goodwill reflects characteristics of the business owner, a source of goodwill that cannot be conveyed with a business. A dissenting view may be found in Ian Tregoning, "Goodwill: another view" (2009) 9(1) *The Tax Specialist* 21, suggesting personal goodwill was inseparable from a broader basket of goodwill that could be transferred with a business. Tregoning explained the dialectic nature of goodwill as a whole item of personal property separate from its sources, but inseparably attached to the business, further in Ian Tregoning, "Goodwill and the stamp duty land tax" [2007] 5 *British Tax Review* 648; Ian Tregoning, "Goodwill in the context of licensing, leasing and franchising: some considerations" (2009) 37(5) *Australian Business Law Review* 296 and Ian Tregoning, "The concept and treatment of goodwill in Australia" [2010] (April) *Corporate Business Taxation Monthly* 9.

4 See, for example, *Healius Ltd v FCT* [2019] FCA 2011 at [38] where goodwill was described as "the right or privilege to make use of all that constituted the attractive force" of a business.

5 *Income Tax Assessment Act 1915*, ss 18(a), 20(e).

6 *Income Tax Assessment Act 1915*, s 18(e).

7 *Income Tax Assessment Act 1997*, s 40-880. The provision was added to the legislation in 2001 but originally only applied to business establishment and termination expenses and expenses incurred to defend against a takeover or a potential takeover. It was extended to intangible benefits other than intangible assets in 2006. An example of an amortisable benefit that is not an asset may be found in *Broken Hill Theatres Pty Ltd v FCT* (1951) 85 CLR 423, where the taxpayer incurred an expense to oppose entry of a competitor into the market.

the capital gains rules. The original cost of acquisition would be taken into account when calculating a gain or loss on the disposal or expiration of an asset. In the case of wasting intangible property, of course, the disposal or expiration would most likely yield a loss, which could only be recognised if the taxpayer had sufficient capital gains to offset against the loss.[8]

Not all taxpayers were restricted in this way when seeking recognition of the cost of acquiring wasting intangible assets. In some cases, fortunate taxpayers were able to portray expenses incurred to acquire fixed-life multi-year intangible assets such as contractual rights as immediately deductible revenue expenses, claiming they were regularly incurred in the operation of their business.[9] The argument could not, however, be made with expenses to acquire goodwill, an asset that is acquired with a business, rather than purchased in the course of carrying out a business. The cost of goodwill acquired with a business can only be recognised if the business to which it is attached is later sold and a portion of the sale proceeds is specifically designated as consideration for the transferred goodwill.

3 Stamp duty cases and the origins of the legal concept of goodwill for income tax purposes

The earliest Australian cases on the meaning and scope of “goodwill” for tax purposes involved interpretion of property transfers that might attract a stamp duty liability.[10] Until the later decades of the 20th century, Australian State stamp duties applied to an extremely broad range of commercial contracts. In most cases, flat rates of duty applied but, in the case of transfers of land, an ad valorem duty applied, meaning the stamp duty charge on the conveyance of land increased in harmony with the value of the land. Not surprisingly, the different treatment of contracts to transfer land and sales of other business assets prompted parties to value sales of businesses carefully and in some cases creatively, with lower values attributed to interests in land and higher values to the transfers of businesses and business assets including accompanying “goodwill”.

A similar issue arose with the sale of land-owning companies. In the absence of countervailing measures, taxpayers might seek to avoid stamp duties on the conveyance of land by holding real property interests through interests in an interposed company and selling the shares in the company as an indirect conveyance of the real property interests. To prevent revenue leakage through these arrangements, State stamp duty laws have extended the stamp duty on transfers of land to also apply to sales of interests in “land rich companies”, that is, companies in which more than a specified percentage of the company’s value (most often 60% to 80%) is attributable to its land holdings.

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8 Examples of expenses for fixed-term, limited life multi-year assets that would be recognised under the capital gains rules include those incurred in *Jupiters Ltd v DCT* (2002) 118 FCR 163 (expenses incurred to acquire a 10-year exclusive casino licence guarantee) and *FCT v Sharpcan Pty Ltd* [2019] HCA 36 (expenses incurred to acquire 10-year gaming machine licences).

9 *BP Australia Limited v FCT* (1965) 112 CLR 386 (cost of acquiring 3 to 10-year tied-house agreements); *Healius Ltd v FCT*, above n 4 (cost of acquiring an exclusive medical services agreement); *FCT v Star City Pty Ltd* [2009] FCAFC 19 (cost of acquiring a 12 year casino licence); in contrast to a 10-year licence for a Brisbane casino was regarded as a capital expense – see *Jupiters Ltd v DCT*, above n 8 which could be recognised as a capital loss when the licence expired, provided the taxpayer had a capital gain it could be offset against.

10 Also in compensatory cases involving land acquisition such as *Minister for Home and Territories v Lazarus* (1919) 26 CLR 159; *Commonwealth v Reeve and Anor* (1949) 78 CLR 411.

Courts considering disputes over stamp duty assessments for the sale of land that was included in the transfer of a business or sale of companies that might be deemed to be land-rich initially drew on UK precedents to interpret claimed attributions of business value or company value to "goodwill". As was noted earlier, UK courts had developed a bifurcated notion of goodwill, distinguishing between "personal goodwill", associated with the vendor of a business, and "locational goodwill", connected with the real property used by the business. Purchasers of businesses that included interests in real property often sought to designate a lower value for the real property and attribute some of the purchase price to the locational goodwill of the business. If the value of a business is attributable in part to the attributes of its location, however, that value should be reflected in the value of the real estate, including leasehold interests, not a separate asset "goodwill" based solely on the property. This would be the case, for example, with the sale of a motel[11] or the transfer of a hotel property where the hotel is not operated by the vendor at the time of sale.[12] Business attributes described (successfully) as goodwill by purchasers seeking to minimise stamp duty on the purchase of real property interests associated with acquisition of a businesss have included a hotel (liquor) licence[13] and the synergies of a going concern manufacturing tangible products[14] or providing services to customers.[15]

Similar synergy value of a going concern may be found where a business is transferred by way of a sale of shares in the company operating the business. In this case, the company's management skills and attributes shown to attract and retain customers can be transferred – the same persons continue in the same roles, reporting to the same employer, which happens to have a new owner. Provided the company can demonstrate that these skills and attributes play a role in attracting custom, purchasers of shares in the company can show that the value of the company is sufficiently attributable to other assets of the company, including goodwill, to shift the company over the valuation threshold that would otherwise see it characterised as a land rich company.[16] In contrast, it would be difficult for a company whose fortunes are ultimately based on exploiting its land resources to show that a significant value of its assets is attributable to goodwill or the synergies of a going concern.[17]

While courts continue to refine the legal concept of goodwill for stamp duty purposes, the fundamental principles were well settled by the time the concept became relevant for income tax purposes. Directly transferred into income tax law was the notional distinction between personal and locational goodwill and the recognition that neither of these were actually severable and transferable, with the value commonly labelled goodwill actually

11 As with the sale of a motel property; see ***Morvic Pty Ltd v Commissioner of State Revenue*** [2002] VSC 171.

12 As with the acquisition of a hotel operating under a competitor's name where following the acquisition the new owner replaced the management with its own and operated the hotel under a brand name it owned; see ***HSH Hotels (Australia) Ltd v Commissioner of State Taxation*** [2005] SASC 39; 58 ATR 276.

13 *Tooth & Co, Ltd v Commissioner of Stamp Duties (NSW)* (1909) 9 SR NSW 652; *The Palace Hotel (Hawthorn) Pty Ltd v Commissioner of State Revenue* [2004] VSC 137; 8 VR 438.

14 As with the sale of an operating manufacturing facility and the land on which it was situated; see ***Commissioner of State Revenue v Uniqema Pty Ltd*** [2004] VSCA 82; 9 VR 523.

15 As with the sale of an aged care hostel and the real property on which it operated; see ***Primelife (Glendale Hostel) Pty Ltd v Commissioner of State Revenue*** [2004] VSC 214; 9 VR 665.

16 See, for example, ***Kizleap Pty Ltd v Chief Commissioner of Stamp Duties*** (2001) 46 ATR 323 (purchaser of a company owning a caravan park showed customers chose to stay because of the good attention of management).

17 This was the case, for example in ***Commissioner of State Revenue v Placer Dome Inc*** [2018] HCA 59 where a mining company sold its output on the world market at prevailing market prices, with internal goodwill having no impact on the sales price, though synergies may have affected the level of profit from sales.

constituting other business attributes such as licences, know-how or going concern synergies.

4 Income tax issues relating to goodwill and business transfers

While neither personal nor location goodwill can be actually transferred when a business is sold, a surfeit of case law reveals that many, if not most, sales of businesses include consideration for what are labelled transfers of goodwill. A closer examination of the cases, however, shows that in most of the cases the business attributes that have been labelled "goodwill" actually constitute separate economic benefits such as lease premiums, licences, non-competition agreements, or notional property creatively used in sophisticated financial arrangements. A variety of rules govern the recognition of the cost of acquiring all these types of actual or mislabelled goodwill. They rarely align with the benchmark tax goal of measuring net income correctly.

There is, however, a group of business sale transactions in which the purchase price is said to include a transfer of goodwill that in fact involves no mislabelled transaction. In these sales, the price paid by the business purchaser exceeds the value of all identifiable assets and benefits being transferred with the excess attributable to the fact that the enterprise is sold as a going concern – that is, the market value of an operating business already generating profits is more than the combined market values of its separate assets. The premium over the value of separate identifiable business assets paid in the acquisition of a business is attributable to genuine goodwill: as noted in section 2, the value added by business synergies and existing custom, the operational systems already in place that generate higher returns and the existing clientele likely to continue to frequent the business. Ironically, a review of the various types of transactions that have generated case law shows that the one type of goodwill transaction that has generated no litigation is the sale of a going concern including the value of actual goodwill.[18]

A key factor that helps explain the structure of transactions said to involve transfers of goodwill and the characterisation of other benefits as goodwill is the non-taxation from 1915 until 1985 of most gains realised as a result of a sale of goodwill and the limited or preferential taxation of these gains after 1985. An understanding of case law thus starts with an appreciation of the factors that left gains from the sale of goodwill out of the tax base prior to 1985 and concessional treatment after that time.

For the first seven decades of income taxation in Australia, the term "income" in the primary assessment provision of the income tax law was accorded a scope far narrower than the notion of economic gain included in the meaning of income in some other jurisdictions.

18 The value of goodwill is also relevant in three other areas of income tax law that have not, to date, generated litigation. Non-residents potentially liable for capital gains tax on the sale shares in an apparently "land-rich" company (more than 50% of the value is attributable to Australian real property owned by the company) may argue the company's value is sufficiently attributable to its goodwill to bring the land value below 50%. Residents may make a similar argument to ensure they qualify for the "participation exemption" which exempts foreign dividends from tax if the company holds active assets, which would include goodwill. Finally, a statutory concept of goodwill is used in the consolidation regime as a residual asset when a company's assets are notionally attributed to a consolidated group. For a discussion of the consolidation regime and goodwill with an example see Michael Walpole, "A conflict of duty - a federal approach to the tax treatment of goodwill and other intangibles" (2003) 18 *Australian Tax Forum* 3, 9-13.

Excluded from "ordinary income", the euphemistic term used to describe amounts treated as income receipts under the somewhat narrow judicial concept of income,[19] were gains labelled capital receipts or capital gains. The primary source of untaxed gains were those realised on disposal of assets for a profit, though a range of other types of gains were also excluded from the tax base including those realised on sales of business and employment rights and gains related to withdrawals from businesses or covenants not to compete or reveal business information.

The narrow tax base undermined the redistributive impact of the progressive income tax and resulted in economic costs from distorted commercial decisions and behaviour as individuals and companies made structured investments and transactions so the gains would satisfy the judicial tests for characterisation as capital receipts. After a preliminary report by a tax review committee in 1974 recommended inclusion of capital gains in the income tax base,[20] the government started preparations for a base broadening exercise which continued after the committee's final report repeated the case for taxing capital gains, albeit on a more relaxed adoption timetable.[21] The Governor-General's unexpected dismissal of the government and its replacement by a conservative coalition government strongly opposed to base broadening in this way put capital gains taxation on hold for a decade during which the capital gains exemption was exploited in a vast array of income tax avoidance schemes.

One commonly used arrangement was the extraction by company vendors of the value of retained earnings as untaxed capital gains through arrangements labelled dividend stripping schemes. As these morphed into the most notorious tax evasion schemes in Australian tax history, bottom of the harbour schemes in which both underlying company profits and the value of extracted retained earnings went untaxed, public concern over the exclusion of capital gains from the tax base escalated.[22]

Revelations of avoidance and evasion based on the capital gains exemption undermined opposition to base broadening and, following publication in 1985 of an internally generated "Draft White Paper" outlining tax reform options,[23] the government announced that capital gains would be added to the income tax base from 20 September 1985. Shortly before the draft legislation was released, the government responded to internal warnings of political risks associated with the base broadening and decided to abandon its plan to impose the tax on gains that accrued from the date on which the tax measures applied and instead announced that the capital gains inclusions would apply only to gains on assets acquired after the commencement of the capital gains measures.

Following a lengthy drafting process, a reform bill was introduced in Parliament in early 1986.[24] The legislation was based on an inclusion measure aimed at the most common type of capital gains, gains realised on the disposal of an appreciated asset. Deeming provisions then created acquisitions and disposals to fit other transactions such as the

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19 The most commonly cited authority for the term is *Scott v Commissioner of Taxation (NSW)* (1935) SR NSW 215, at 219.

20 Taxation Review Committee (Justice K W Asprey, chair), *Preliminary Report* (Australian Government Publishing Service, 1974).

21 Taxation Review Committee (Justice K W Asprey, chair), *Full Report* (Australian Government Publishing Service, 31 January 1975) (Asprey Report).

22 The mechanics are described in Abe Greenbaum, *Australian income tax law: study guide and casebook companion* (Law Book Company, 1991), p 217.

23 Australian Treasury, *Reform of the Australian Tax System* (Draft White Paper) (Canberra, 1985).

24 Income Tax Assessment Amendment (Capital Gains) Bill 1986; introduced to Parliament on 22 May 1986. See also Leon Gorr, "How CGT affects goodwill on sale of business" (1986) 50 *Chartac: Taxation Report* 1.

creation of rights under a negative covenant or the expiry of a contract into the primary charging measure.

Seeking to mitigate political risks from the base broadening reform, the government adopted a remarkably generous transition rule, exempting from tax under the capital gains regime (now called the CGT regime) all gains realised on assets acquired prior to the commencement date of the tax, 20 September 1985.

As the capital gains provisions applied to disposals of "assets", the application of the rules to goodwill depended on the characterisation of goodwill as an asset that could be disposed of to another person. On its face, this was an improbable characterisation.[25] Among other things, assets are capable of ownership and transfer of ownership. Ownership of tangible assets such as real property and personal property can be transferred by a shift of physical position combined, where required, by a change in registration. Intangible property such as intellectual property recognised by statute and rights created by a contract such as a loan agreement or commercial contract can be assigned (legally transferred) under the common law and the law of equity. In contrast, there is no law that provides "title" to a type of property called goodwill and no obvious way of enforcing a contract that purports to transfer goodwill in the absence of any attribute of ownership that could signify a shift in the asset to be transferred. It has nevertheless been accepted by courts, taxpayers and tax authorities that it is possible to transfer the value of a business attributable to its goodwill with the remainder of an operating business.

The remainder of this section considers the four types of transactions involving mislabelled goodwill that are found in Australian income tax "goodwill" cases.

4.1 Lease premiums

The earliest reference to goodwill in Commonwealth income tax legislation appeared in the 1915 income tax Act, the first federal income tax law. By this time, income tax laws had already been in place in all Australian States for a number of years. In the period prior to the adoption of Commonwealth income taxation, lease premiums were commonly used by landlords and tenants to achieve a targeted overall consideration for the use of property while reducing regular rent payments. Recognising lease premiums as substitutes for assessable rent, State courts considering appeals to assessments under State income tax law had no difficulty characterising lease premiums as substitutes for assessable rent that constituted assessable income in their own right.[26] While State laws accordingly had no provisions explicitly including lease premiums in assessable income, in some instances they did explicitly allow tenants to depreciate the cost of lease premiums over the life of the lease, provided the requisite nexus with the derivation of assessable income was established.[27]

The drafters of the Commonwealth income tax statute appeared less confident than their State counterparts had been about the judicial characterisation of lease premiums as assessable income and accordingly inserted in the 1915 Act a measure that included

25 Slater has observed that a more accurate description of goodwill is "a property, that is, a quality or attribute", not property capable of disposition or conveyance, in A H Slater QC, "Nature of goodwill" (1995) 24(1) *Australian Tax Review* 31.

26 See, for example, *Re Income Tax Acts 1902-1907* [1912] QWN 5.

27 See, for example, *Income Tax Act 1902* (Qld), s 16(ix).

lease premiums in assessable income,[28] along with an amortisation rule allowing tenants to depreciate the cost of those premiums.[29]

A common practice by landlords seeking to circumvent the effect of State judicial characterisation and Commonwealth legislative treatment of lease premiums was to attribute a portion of the payment received as consideration for the sale of goodwill, yielding what was, at that time, a non-assessable capital asset where landlords transferred a business or business licence along with the grant of a lease. While these attempts often floundered on the facts,[30] administrative experience, particularly in Queensland and Victoria, revealed increasingly artificial attempts to characterise payments on the grant of a lease in combination with the transfer of a business as consideration for the transfer of goodwill.[31] In 1930, the Commonwealth responded to these manoeuvres by extending the lease premium inclusion and depreciation provisions to include payments in respect of "goodwill".[32] The broad measures made no distinction between personal and location goodwill, leading to a legislative presumption that all goodwill was ultimately connected with real property.[33]

At this time, businesses in Australia faced significant tax compliance costs as they filed both State and Commonwealth income tax returns using sometimes widely divergent tax rules. Seeking a solution to the problem, the Commonwealth government commissioned the Hon (later Sir) David Ferguson, a retired New South Wales Supreme Court justice, to chair a Royal Commission on Taxation charged with the task of preparing a report on simplification and standardisation of the Commonwealth and State income tax laws.[34] Following publication of the Royal Commission reports and discussions between Commonwealth and State officials, the Commonwealth enacted a new Income Tax Assessment Act in 1936 that served as a model for harmonised income tax laws subsequently adopted in the States.

The Royal Commission looked at both broad conceptual and policy issues and narrower technical tax issues in its reports. A discrete section of the Royal Commission's third report was devoted to the tax implications of leases. The report noted the traditional distinction between location goodwill and personal goodwill, suggesting that only consideration for the former should be treated as assessable income. The report also suggested that since payments for goodwill associated with property subject to a lease were in fact substitutes for higher rent, they should be assessable to the landlord in equal instalments over the life of the lease, paralleling the recognition of the payments by lessees where the leased premises were used in the production of income.[35] There was no discussion in the document

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28 *Income Tax Assessment Act 1915*, s 14(d).

29 *Income Tax Assessment Act 1915*, s 20(i). Initially the amortisation was allowed for a sinking fund using the concept of recouping expenditure. It was replaced by the cost-based depreciation – "the sum divided by the number of years of the unexpired period of the lease" (as amended by *Income Tax Assessment Act 1918*, s 16(e)).

30 See, for example, *Re Income Tax Acts 1902-1907* [1913] QWN 16 (evidence showed rental payments significantly below market value, countering taxpayer's claim that part of lump sum was for transferred business goodwill); *Daniell v FCT* (1928) 42 CLR 296 (no evidence that either party regarded part of the payment to be consideration for goodwill).

31 Explanatory Memorandum to the Income Tax Assessment Bill 1922-1929, 26-27.

32 *Income Tax Assessment Act 1930*, ss 6(f) and 12(c), respectively, added goodwill to s 16(d), the inclusion provision, and s 25(i), the expense provision, of the *Income Tax Assessment Act 1922*.

33 Explanatory Memorandum to the Income Tax Assessment Bill 1922-1929, 26-27.

34 Royal Commission on Taxation (D G Ferguson, chair), *Reports of the Royal Commission on Taxation* (Commonwealth Printer, 1934-1936). See further S Mackellar White, "Royal Commission on Taxation" (1934) 6(22) *The Australian Quarterly* 73-81.

35 Royal Commission on Taxation, *Third Report of the Royal Commission of Taxation* (1934), para 757.

as to how personal goodwill might actually be transferred to a new business owner. At the same time, there was no explanation of what constituted personal goodwill and it may be that the Commission regarded actual goodwill, the value of going concern synergies, as a form of "personal" goodwill.

The 1936 rewrite of the Income Tax Assessment Act partly adopted the recommendations of the Royal Commission. The reference to lease premiums in the inclusion measure narrowed the scope of the measure as it applied to goodwill by limiting the inclusion to consideration for goodwill "attached to or connected with" land that was subject to a lease.[36] However, the suggestion that the amount should be recognised as income over the life of the lease was not adopted, leaving the full amount assessable when derived in the same way as all lease premiums had previously been treated. On the expense side, payments for locational goodwill remained depreciable over the lease period.

The drafting of the 1936 provisions implicitly acknowledged the distinction in tax law between personal goodwill and location goodwill. The changed scope of the rule had relatively little impact, however, with courts regularly finding that goodwill sold on the transfer of a business was connected with an associated leasehold interest unless the contract included specific commitments by the vendor to draw custom for the new owners.[37] The presumption was further extended to consideration for non-competition agreements provided by business vendors, which were consistently viewed as connected to leasehold interests provided to the purchasers unless proven otherwise by the vendor.[38]

In the aftermath of the Second World War, the Commonwealth looked to modernise and improve the income tax legislation and to this end, in 1950, appointed a Committee on Taxation to report on different aspects of the tax.[39] The Spooner Committee, as it became known, evolved into a standing committee and, over its five-year life, issued 37 reports in response to references from the Treasurer. By the time the Committee released its report on leases,[40] it had become clear that the reverse onus imposed by the courts on taxpayers in respect of the lease premium provisions had extended the reach of the measures to consideration that was clearly outside the narrowing policy intention of the 1936 amendments. In particular, the characterisation regularly led to the inclusion in assessable income of payments for non-competition covenants that were unlikely to have affected therental value of the premises and seemed not to be substitutes for otherwise higher rent.[41]

The Committee agreed there was a theoretical distinction between personal and location goodwill but suggested it had proved to be almost impossible to make the distinction

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36 Definition of "premium", s 83, *Income Tax Assessment Act 1936*.

37 *FCT v Williamson* (1943) 67 CLR 561 (purchaser of chemist shop allowed to depreciate cost of goodwill over lease period); *Watson v FCT* (1953) 87 CLR 353 (vendor of newsagency assessable on consideration of goodwill where leasehold rights assigned for no consideration). Cf. *Phillips v FCT* (1947) 75 CLR 332 (seller of newsagency not assessed on gains from the disposal of goodwill attached to exclusive agency agreements with newspaper companies where a separate property owner not connected to newsagency business vendor provided a lease to the purchaser).

38 See below, section 4.4.

39 Commonwealth Committee on Taxation (E S Spooner, chair) (Australian Parliamentary Papers, 1950-1955). See further Graham Hill, "Tax reform: a tower of Babel; distinguishing tax reform from tax change" (2005) 1(2) *Journal of the Australasian Tax Teachers Association* 1.

40 Commonwealth Committee on Taxation, above n 39, "Leases" (reference no 17, 16 January and 22 July 1952), paras 10-39, also published in Parliamentary Papers 51-53: 502 (1952) (Commonwealth).

41 See further Sir Arthur Fadden, Second Reading Speech on the Income Tax and Social Services Contribution Assessment (No 3) Bill 1952, Commonwealth Parliamentary Debates, House of Representatives (18 September 1952).

in practice. The rule then in effect, the Committee noted, had generated considerable litigation but with little revenue effect as the assessable character of any payment for goodwill received by the vendor that was found to be associated with a leasehold interest was likely offset by a deduction by the lessee. The solution, the Committee suggested, was for the tax authorities to step away from the characterisation issue and remove goodwill payments from the lease premium measures unless the lessor and lessee jointly agreed the payment for goodwill should be treated as a premium for leasehold interest in land on which the business operated. The recommendation was accepted and the lease premium measures were amended to exclude payments for non-competition covenants or payments for goodwill unless they were explicitly described in the contract as goodwill[42] and both the vendor and purchaser had agreed in writing to treat the consideration for goodwill as a lease premium.[43]

Litigation over the nature of goodwill payments largely evaporated following the 1952 amendments, although many continued to view the lease premium provisions and election procedure as unwieldy and complex. Seven years later the Commonwealth appointed another Committee on Taxation under the chairmanship of G C Ligertwood with somewhat narrower terms of reference focusing on unnecessary complexities, anomalies and inconsistencies in the income tax law.[44] The Ligertwood Committee's recommendation on goodwill payments largely sought to reverse the 1952 amendments, suggesting that the Commissioner should be responsible for characterising goodwill payments where they were not directly tied to a lease by contractual arrangements.[45]

The Committee's recommendations on leases generally were implemented in a manner quite different from that envisaged in its Report. An amending Act enacted in 1964, three years after the Report was tabled, discontinued the operation of the lease premium Division except as it applied to mining leases, but at the same time added a separate measure that treated lease premiums as assessable income when derived.[46] The replacement provision made no mention of payments for goodwill and no corresponding provision was adopted to allow persons paying lease premiums to depreciate the outgoings where the lease was used for income producing purposes. Mention of goodwill in the lease premium rules that had been retained for mining taxpayers was removed in 1968.[47]

There the matter rested until the adoption in 1986 (with effect from 1985) of the capital gains tax regime. As noted, the transitional rule for the CGT regime exempted from tax all gains realised on assets acquired prior to the commencement date of the tax, 20 September 1985. It recognised, however, that the transitional rule could open the door to abuse by real property owners who might carve off new leasehold interests after the introduction of capital gains taxation and claim they were merely disposing of part of an asset acquired prior to the commencement of the capital gains measures. To preclude this possibility, a measure was added to the capital gains regime to treat disposals of leasehold interests

42 Amendment of definition of "premium", *Income Tax Assessment Act 1936*, s 83, by *Income Tax and Social Services Contribution Assessment (No 3) Act 1952*, s 15.

43 *Income Tax Assessment Act 1936*, s 83A, inserted by *Income Tax and Social Services Contribution Assessment (No 3) Act 1952*, s 16.

44 Commonwealth Committee on Taxation (G C Ligertwood, chair) *Report of the Commonwealth Committee on Taxation* (Government Printer, 1961) (Ligertwood Report).

45 Ligertwood Report, above n 44, at para 342.

46 *Income Tax Assessment Act 1936* s 26AB, added to the Act by *Income Tax and Social Services Contribution Assessment (No 3) Act 1964*, s 9.

47 *Income Tax Assessment Act (No 2) 1968*, amending *Income Tax Assessment Act 1936*, s 88B.

as the creation and disposal of an asset, removing the transactions from the exclusion for gains realised on the disposal of assets acquired prior to 20 September 1985.[48]

The explicit inclusion of leasehold premiums in the CGT provisions created an overlap with the provision including the payments directly into assessable income. The situation was not resolved until 1997 when the original measure was explicitly restricted to premiums paid in respect of leases granted prior to the introduction of the capital gains regime.[49]

Lease premiums subject to the CGT rules are not eligible for the 50% exclusion of capital gains (the "CGT discount") available to individuals.[50] Disposals of goodwill, on the other hand, may be eligible for the discount, once again creating an incentive for taxpayers to characterise lease premiums as consideration for transfers of goodwill. There has been no litigation since the adoption of the capital gains discount considering attempts by taxpayers to exploit the inconsistent treatment of the two types of gain by characterising *de facto* lease premiums as consideration for the sale of goodwill.

Over the course of their 34-year life, the goodwill references in the income tax Division devoted to lease premiums prompted important litigation that helped to build further the judicial concept of goodwill originally developed for stamp duty purposes. In policy terms, however, the legacy of these decisions may be limited. The cases confirm a fundamental distinction in the legal notion of goodwill between personal goodwill based on business attributes unrelated to the land on which the business operates and locational goodwill that is in essence a substitute for a lease premium that is itself a substitute for higher rent. The income tax law, in turn, provided a semi-sound policy response, requiring lessors to recognise the substituted payments as assessable income when received and allowing lessees to depreciate the payments over the course of a lease. However, as the Spooner Committee noted, the immediate taxation of lessors was inconsistent with the rationale for including the amounts in assessable income as, in effect, a substitute for pre-paid rent.

The current treatment of lease premiums as capital gains to lessors and capital losses to tenants is inconsistent with tax principles and a backward step from the former law which, appropriately, allowed lessees to recognise the cost of lease premiums over the life of the lease. Ideally, recognition of the gain for the landlord should also take place over the lease period. As lease premiums do not qualify for the concessional 50% capital gains exemption,[51] landlords are presumably largely indifferent between the current recognition as capital gains and the former rule treating the gains as statutory income. Where lease premiums are mislabelled as consideration for locational goodwill, the landlord remains assessable on the payment but the lessee loses recognition of the cost unless it can manufacture a later disposal of the mislabelled goodwill, at which time it will only be able to recognise the cost if there is a capital gain against which it could be offset. It could be expected that tenants would insist on lease premiums being labelled as such and not as acquisitions of goodwill if taxpayers were able to recognise the cost of lease premiums over the lease period.

48 *Income Tax Assessment Act 1936*, s 160ZS(1), transferred into the *Income Tax Assessment Act 1997* as CGT Event F1, s 104-110(1). See further section 6 of this article, below.

49 *Tax Law Improvement Act 1997*, adding s 26AB(1A) to *Income Tax Assessment Act 1936.*

50 They are disqualified by *Income Tax Assessment Act 1997*, s 115-25(3)(e).

51 *Income Tax Assessment Act 1997*, s 115-25.

4.2 Repo loans

Prior to the adoption of the capital gains measures in 1986, with effect from 20 September 1985, almost all cases considering the meaning of goodwill in income tax law concerned the explicit mention of goodwill in the lease premium provisions. Adoption of the CGT regime led to a number of cases reconsidering the nature of goodwill in different contexts.

The first "capital gains" case involving goodwill, *FCT v Krakos Investments Pty Ltd*,[52] actually concerned a simple financial arrangement – an interest-free loan by the purchaser of a business to the vendor structured as a "repo loan" that was characterised by the vendor, for tax purposes, as a supposed sale and planned repurchase of "goodwill".

The transaction arose in the context of the sale of a business that had been acquired by the vendor in December 1984, nine months prior to the commencement of the capital gains tax. The sales contract provided for the transfer of a hotel business and, separately, the goodwill associated with the business, as well as a five-year lease of the premises in which the business operated. In economic terms, the payment for goodwill in the case was neither consideration for the sale of goodwill nor a lease premium. The sale contract included a put option that could be used by the purchaser to require the vendor to re-acquire the goodwill after five years for the original "sale" price. The arrangement was thus a standard repo loan transaction yielding a five-year interest-free loan by the lessee to the lessor. The sale price for the business presumably reflected the interest savings enjoyed by the landlord accessing the interest-free funds for the duration of the lease.

The question put to the Full Court of the Federal Court was whether the payment received by the vendor was, as the vendor claimed, consideration for goodwill transferred to the lessee that had been acquired by the vendor prior to the commencement of the CGT, or was actually a lease premium paid for a lease created after 19 September 1985. Considering the planned return of the payment to the tenant at the end of the lease period, the Court accepted the vendor's argument that the payment should not be characterised as a lease premium, without specifying exactly what was acquired for the payment.[53]

Discussion of the nature of goodwill was thus obiter to the decision and jurisprudence on the meaning of goodwill for capital gains tax purposes. The implications in terms of the judicial concept of goodwill were important in terms of the capital gains tax transitional rule, however, as the Court implicitly accepted the vendor's assertion that goodwill was an asset of a business that came into existence when the business commenced.

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52 *FCT v Krakos Investments Pty Ltd* (1995) 61 FCR 489; 32 ATR 7. See commentary in Grant Cathro, "The sale of goodwill" (1996) 25(3) *Australian Tax Review* 129; Rob Jeremiah, "Leases, lease premiums, goodwill and lease incentives: capital gains tax etc" (1997) 43 *Property Law Bulletin* 2; Robert Jeremiah, "TR 96/24 – income tax, capital gains: guidelines to determine whether an amount described in a sale of business agreement as consideration for goodwill is properly characterised as a lease premium" (1997) 43 *Property Law Bulletin* 20; Jim Richardson, "Goodwill or lease premium" (1996) 48(2) *Australian Company Secretary* 77, 79 (recharacterisation to consideration). See further a comparison with *FCT v Murry* (1998) 193 CLR 605 (above n 2) in Grant Cathro, "Goodwill: 'now you see it, now you don't'" (1996) 25(4) *Australian Tax Review* 169; Ian Tregoning, "Goodwill at the crossroads" (1997) 21(2) *Accounting Forum (Adelaide)* 133.

53 Prior to the *Krakos* decision, the Commissioner had indicated in *Taxation Ruling* IT 2535 that the ATO considered payments described as "goodwill" in a contract for the sale of a hotel would be treated as a lease premium (and hence assessable as a capital gain even when the lease was provided on property acquired prior to the commencement of the capital gains tax) if the goodwill was related to the hotel's location. The Commissioner subsequently retreated from the economic substance approach adopted in that ruling and in *Taxation Ruling* TR 96/24 suggested that some weight would be given to the form of the transaction, adding that the existence of a put option for the resale of goodwill would be relevant as it was in *Krakos.*

The notional sale and repurchase of goodwill as the basis for a repo loan may be a true outlier in the panoply of Australian goodwill cases, with goodwill used precisely because of its indeterminacy and the absence of any other asset that could be transferred and reacquired simply by way of contract only. The tax treatment of the transfer and reacquisition arises only because of the long-established policy of Australian courts to accept restructured loans at face value based on their supposed form rather than the actual commercial substance. Well-known previous examples include the characterisation of vendor-finance as "instalment" sales with interest recognition spread evenly over the payment period[54] and the schemes to recast blended payment loans as annuities, again to defer recognition of interest payments.[55] In the absence of any indications that Australian courts will adopt a substance over form approach to interpreting loan substitution arrangements, the appropriate legislative response is to ensure repo loans are treated in the same manner as the blended payment loans for which they substitute in the Taxation of Financial Arrangements (TOFA) legislation. The problem is not one of recognising the cost of goodwill.

4.3 Licence transfers

The adoption of the capital gains tax provisions in 1986 saw the reintroduction of the term "goodwill" into the text of income tax law. The term was included in a concessional measure in the capital gains tax regime. Passage of the capital gains measures in 1986 had been politically challenging. While the government had no difficulty achieving passage of its draft legislation in the lower House where it held a majority of the seats, to shepherd the amendments through the Senate required several amendments to obtain support from the Democrats, a minor party that held the balance of power in the upper House. One of the Party's key demands was a concession for persons selling small businesses and farms. The issue had been considered by the policy advisors who prepared the Draft White Paper and that document set out a series of reasons why vendors of farms and small businesses should not receive concessions different from those available to other taxpayers.[56] The Democrats made it a condition for their support for the wider legislative package, however, and the government conceded the point to move the reform through the upper House.

The concession agreed to by the government and minority party as its condition for passing the capital gains measures was the adoption of an exemption for 20% of the gain attributable to goodwill included in the sale of a business that had a net value of less than AUD 1 million.[57] An integrity rule prevented taxpayers from splitting businesses to fall below the threshold by consolidating the value of associated businesses when taxpayers sought to access the concession.[58]

The legislation provided no definition of goodwill subject to the concession and neither the government nor the opposition sponsor attempted to offer much of an explanation

54 See, for example, *L'Estrange v FCT* (1978) 8 ATR 410 and *Spence v FCT* (1967) 15 ATD 80.

55 *ANZ Savings Bank Ltd v FCT* (1993) 25 ATR 369 (Full Federal Court). The recasting of the loan as an annuity was accepted by the High Court on appeal, with the appeal issue confined to the character of an annuity payment flowing through a unit trust: (1998) 194 CLR 328 (High Court).

56 Australian Treasury, *Reform of the Australian Tax System*, above n 23, at paras. 7.23-7.26.

57 *Income Tax Assessment Act 1936*, s 160ZZR(1). For further analysis see J H Momsen, "Disposal of goodwill and liquidator's distributions" (1992) 4(5) *CCH Journal of Australian Taxation* 13 (discussing how assets could be held outside a company to keep the value below AUD 1 million); Wouter Scholtz, "Incorporated business and s 160ZZR: goodwill or artful malice?" (1993) 7(8) *Australian Property Law Bulletin* 66 (discussing whether the concession can be accessed through a company).

58 *Income Tax Assessment Act 1936*, s 160ZZR(2).

for the rule. The minor party that sponsored the concession described its win as a major concession and a real gain for small business but offered no rationale for special treatment for this sector.[59] Nor did the Explanatory Memorandum accompanying the bill introducing the capital gains measures, instead simply restating the provision in alternative language.

While neither the government nor the sponsor could provide an explanation for the concession, a press interview by the leader of the opposition explaining his party's opposition to the entire capital gains package inadvertently provided a possible rationale. The leader of the opposition noted that small business operators did not have superannuation savings and relied on the proceeds of sales of their businesses, including consideration for the transfer of goodwill, for their retirement security.[60] At the time, superannuation funds enjoyed generous tax exemptions and a goodwill concession could be seen as providing small business owners with a concession paralleling that available to employees with superannuation savings.

A second inadvertent possible rationale might be drawn from the Senate debates on the capital gains tax bill where it was noted by an opposition senator that the capital gains measures provided cost base indexation for other assets but no indexation was available for goodwill which might accrue over the life of a business with no cost base to index.[61] The absence of a cost base to index revealed the weakness in this argument, however, as indexation was intended to limit the tax base to real gains where the proceeds of disposal included recovery by vendors of the after-tax amounts they had invested to acquire assets. There was no similar recovery of after-tax amounts by vendors of goodwill attached to a business.

The concession attracted relatively little attention until late 1991 when the Liberal opposition released an economic manifesto, *Fightback!*, that in modified form was to become the party's election platform for the 1993 federal election.[62] In addition to a proposal for a broad-based goods and services tax (GST), the document outlined a number of proposed income tax reforms, including significant modification of the CGT concession for sales of goodwill, with a 50% exemption for very small businesses phasing out in two steps to no relief where businesses were sold for more than AUD 2 million. The Labor government countered in early 1992 with its own manifesto, *One Nation*, which proposed an increase in the goodwill gain exemption from 20% of the gain to 50% of the gain while raising the eligibility threshold from AUD 1 million to 2 million, with annual indexation of the threshold.[63]

The enhanced concession was enacted into law later that year.[64]

In early 1996, the Coalition parties, then in opposition, released an election platform that proposed an expansion of capital gains concessions for small business owners with a

59 Senator John Siddons, "Democrats negotiation concessions on tax package", Press release P.R. NO. 85/334 (28 November 1985).

60 Hon John Howard (Opposition Leader), transcript of press conference (20 September 1985), p 9.

61 The argument could be extrapolated from the observations of Senator David Brownhill on the Income Tax Assessment Amendment (Capital Gains) Bill 1986, Commonwealth Parliamentary Debates, Senate (5 June 1986), p 3427.

62 Coalition Parties, *Fightback! It's Your Australia*, authorised by John Hewson and Tim Fischer (Canberra, 1991).

63 Hon Paul Keating (Prime Minister), *One Nation: statement by the Prime Minister* (Australian Government Printing Service, 26 February 1992), pp 92-93.

64 *Taxation Laws Amendment Act (No 2) 1992*, ss 45, 46. A case study explaining the operation of the enhanced concession can be found in Jack Stuk, "New strategies for maximising goodwill exemptions" (1992) 111 *Chartac: Tax Practice Ideas* 2.

"rollover" regime where proceeds from the sale of some or all active business assets held for at least a year prior to disposal (including goodwill) were reinvested in new active business assets and a retirement exemption up to the lifetime limit of AUD 500,000 where the vendor was aged 55 or older and deposited the proceeds into an approved retirement fund.[65] The proposals were incorporated into the Budget following the Coalition's election to government later that year and legislated in 1997 with an AUD 5 million small business threshold.[66] A qualification for the active business assets rollover which had been included in the original Budget proposal that the concession would be subject to a "like kind business" test[67] was abandoned as being too administratively cumbersome.[68]

The 50% goodwill exemption continued in effect following adoption of the active assets rollover and exemption for amounts paid into eligible retirement savings funds and small business owners continued to access the concession when they had no plans to acquire replacement assets or invest the proceeds in a retirement fund. However, the cap for small businesses eligible for the 50% goodwill exemption remained at AUD 2 million, indexed from the 1992/93 income year, in contrast to the AUD 5 million small business threshold used for the active business asset rollover and proceeds invested in retirement savings concessions.[69]

The following year, 1998, the 50% exemption for goodwill gains, along with the core provisions of the capital gains regime, were shifted from the *Income Tax Assessment Act 1936* to the *Income Tax Assessment Act 1997*.[70] The active asset rollover and retirement savings concessions remained in the 1936 Act until 1999 when they were separately transferred into the reconstituted capital gains provisions in the *Income Tax Assessment Act 1997*.[71]

A year later, in 1999, the government received a commissioned report on reform of business taxation, known commonly as the "Ralph Review" after its chairman, John Ralph,[72] which recommended a universal 50% exemption for capital gains realised on the disposal of assets held for at least 12 months to be available to all individuals and applicable to gains on both business and investment assets. At the same time, the Review suggested expanding the 50% exemption for goodwill gains realised by small business owners to a general exemption of half the capital gains realised on the disposal of any active assets owned by a small business for at least a year prior to disposal. It also suggested increasing the AUD 2 million cap on the eligibility threshold to AUD 5 million to align with the higher threshold available for the active asset rollover concession and the exemption for gains on assets where the proceeds were invested in eligible retirement savings plans.

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65 Liberal-National Party Coalition, *A new deal for small businesses: The Federal Liberal/National Coalition's small business policy* (1996).

66 *Income Tax Assessment Act 1936*, Pt IIIA, Divs 17A, 17B.

67 Australian Treasury, ***Budget 1996-97: Budget Statement 4, Revenue Measures*** (20 August 1996), pp 4-20.

68 Hon Peter Costello (Treasurer), "CGT rollover relief for small business: 'like kind' business test", press release P.R. No. 124 (3 December 1996). The design of the measure is discussed in Graeme Cooper, "Goodwill and rollovers" (14th National Convention Paper, Taxation Institute of Australia, March 1999).

69 See, for example, ***Sherlinc Enterprises Pty Ltd and FCT*** [2004] AATA 113; 55 ATR 1001 where the taxpayer was unable to qualify for tax relief under the general business to new business rollover but was still able to access the 50% goodwill exemption.

70 *Tax Law Improvement Act (No 1) 1998*. The new 50% active asset exemption was placed in subdiv 118-C, *Income Tax Assessment Act 1997*.

71 *Taxation Laws Amendment Act (No 4) 1999* shifted the two regimes respectively from Divs 17A and 17B, *Income Tax Assessment Act 1936* to Div. 123 and subdiv. 118-F, *Income Tax Assessment Act 1997.*

72 Review of Business Taxation (John Ralph, chair), *A tax system redesigned – more certain, equitable and durable* (July 1999) (Ralph Review) s 17.

The Ralph Review recommendations were accepted by the government and legislated in 1999. A new small business concession Division was added to the capital gains regime[73] and the 50% active asset exemption inserted into the new Division.[74] At the same time, the existing active assets rollover and retirement savings investment concessions were shifted into the new Division.[75]

Concomitantly with the passage of the Ralph Review recommendation, the government introduced a new concession not considered by the Ralph Review, a complete exemption from tax of gains realised on the sale of small business assets held continuously for at least 15 years prior to sale.[76] Eligibility tests were streamlined for all four concessions with a standard AUD 5 million, later increased to AUD 6 million,[77] small business threshold.

The four capital gains tax concessions applied to "active assets" which are defined to include goodwill.[78] An asset must have been an active asset for a minimum of 7.5 years to qualify for the 15 year holding period exemption.[79] While the last three concessions operate independently, the 50% small business active asset exemption operated cumulatively with the general 50% capital gains exemption for individuals, effectively exempting 75% of the gain from tax.

The various concessions for gains on the transfer of goodwill that have been in place since 1985 have no doubt induced business vendors to characterise generous portions of the consideration received on the sale of the business as payment for transferred goodwill. The inducement to allocate consideration to the transfer of goodwill will, however, be offset to some degree by the purchaser's interest in seeing consideration attributed to assets such as trading stock or depreciable property that can give rise to immediate or serial depreciation deductions.

The limited number of cases considering the nature of goodwill in the context of the capital gains concessions suggests that the Commissioner has generally accepted taxpayers' generous allocations of consideration on the sale of a business to the transfer of goodwill. In the 34 years since the notion of goodwill was included in the capital gains regime, there has only been one reported assessment setting aside the taxpayer's allocation of sale proceeds to a transfer of goodwill.

The only case considering goodwill in the context of the capital gains concession for gains on the sale of a business including value for the transfer of the goodwill of the business involved the transfer of a perpetual licence. A crucial component to the derivation of income through many regulated sectors is obtaining a perpetual licence allowing the business to operate. These are often tied to general or specific locations. Taxi licences are an example of licences tied to general location – a city will issue a fixed number for the city, though holders can operate anywhere in the licence area. Hotel and liquor licences are examples of licences connected with very specific locations. These cannot be transferred separately

73 *New Business Tax System (Capital Gains Tax) Act 1999*, introducing Div 152, *Income Tax Assessment Act 1997.*

74 *Income Tax Assessment Act 1997*, subdiv 152-C. The continuing importance of goodwill in the new concession was noted in Michael Walpole, "The fate of goodwill after Ralph" (2000) 3(5) *Journal of Australian Taxation* 344.

75 *Income Tax Assessment Act 1997*, subdivs 152-D, 152-E.

76 *Income Tax Assessment Act 1997*, subdiv 152-B.

77 From 1 July 2007: *Income Tax Assessment Act 1997*, s 152-20.

78 *Income Tax Assessment Act 1997*, s 152-40(1)(b).

79 *Income Tax Assessment Act 199*7, s 152-35.

from the premises with which they are tied. In all cases, profits from licensed businesses are connected to the monopoly or oligopoly rights enjoyed by the licence holder.

As with the relationship between "goodwill" and so many business attributes, the relationship between perpetual licences and goodwill was first explored in detail in stamp duty cases where purchasers, very often successfully, sought to attribute part of the purchase price of ongoing businesses to goodwill, including the benefit of licence transfer, rather than to a dutiable interest in real property.[80] The goal of characterising licence transfers as transfers of goodwill shifted to business vendors following the adoption of the capital gains tax effective from 1985 as sellers tried to take advantage of the concessional treatment for profits realised on the sale of goodwill.

In 1998, six years after the exemption concession for gains on the sale of small business goodwill was increased from 20% to 50%, the first and only case testing the meaning of goodwill for the purpose of the capital gains tax concession, *FCT v Murry*,[81] was heard by the High Court. The taxpayer in this case had sold a taxi licence for a profit and claimed the value of the licence derived from the oligopolistic rights its holder enjoyed, a benefit that amounted to goodwill as the term was intended to mean for purposes of the enhanced capital gains concession which came into effect shortly before the transaction took place.[82]

The Court reiterated the conventional legal view that although goodwill was considered a distinct asset of a business, it could not exist separately from the business or be transferred without a transfer of the business. To attribute the sale proceeds to a transfer of goodwill, therefore, the taxpayer would have had to show there had been a transfer of a business along with the transfer of its licence rights, assuming they could be characterised as a type of goodwill. The taxpayer failed when the High Court concluded the transfer of the taxi licence in this case was not the transfer of a business as the transferors did not actually carry on the business but instead had leased the licence to a taxi driver who operated a business using his own vehicle. As a result, the taxpayer did not qualify for the 50% exemption for goodwill gains.

While much of the Court's discussion of goodwill was arguably *obiter* given the narrower grounds on which the decision rested, the High Court appeared to have taken a wider view of goodwill from something that attracted custom to anything that added value to business

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80 See, for example, ***Tooth & Co, Ltd v Commissioner of Stamp Duties (NSW),*** above n 13; ***The Palace Hotel (Hawthorn) Pty Ltd v Commissioner of State Revenue,*** above n 13.

81 *FCT v Murry*, above n 2. A comprehensive summary of the principles set out in the judgment is found in Michael Walpole, "When is goodwill not goodwill?" (1999) 2(1) *Journal of Australian Taxation* 48. See also Ian Tregoning, "The meaning and nature of goodwill in the tax context" (2010) 39(3) *Australian Tax Review* 123; John Mison, "When is 'goodwill', not 'goodwill'? The Murry decision" (Twilight Seminar Paper Western Australia, Taxation Institute of Australia, 24 September 1998); [Current topic], 'Goodwill hunting' (1998) 33(2) *Taxation in Australia* 62; George Raitt, "Licences, goodwill and CGT" (1998) 72(8) *Law Institute Journal* 78; Grant Cathro, "The High Court on goodwill" (1999) 28(1) *Australian Tax Review* 57; C J Bevan, "Resuscitating the old jurisprudence on goodwill" (1998) 27(3) *Australian Tax Review* 148 (discussing implications of the Murry case); Harry Rigney, "Goodwill: is it good or not?" (State Convention Paper, Taxation Institute of Australia (Queensland Division), May 1999). For commentaries on the lower court rulings in the case prior to the High Court decision, see Harry Rigney, "Murry's case: goodwill considered by the High Court" (1998) 112(4) *The Australian Banker (Melbourne)* 156 (speculation after decision by the single High Court judge); Ian Tregoning, "*FCT v Murry*: the Federal Court takes licence with goodwill" (1996) 3(2) *Deakin Law Review* 201; Andrew Burns, "Goodwill hunting" (2019) 53(9) *Taxation in Australia* 475; Greg Pearson, "The goodwill roll-off effect in partnerships" (2000) 3(1) *Journal of Australian Taxation* 56.

82 The concept of monopolistic goodwill was considered prior to the High Court decision in Frank Zumbo, "Transfers: 'monopoly' goodwill" (1997) 5(3) *Taxation in Australia (Red Edition)* 139; Michael Walpole, "Income tax: some observations on the taxation of monopoly goodwill" (1998) 27(2) *Australian Tax Review* 122.

or increased its profitability. The suggestion prompted much discussion comparing the legal and accounting concepts of goodwill.[83] The apparently wide definition also led to speculation on when a person selling a business after the introduction of capital gains tax could claim the goodwill was actually in the business prior to 20 September 1985, leaving the gain out of the scope of the capital gains regime.[84]

More significantly, the ruling led some to argue that the value of holding a statutory licence that yields monopoly or oligopolistic profits can be largely attributed to the goodwill of holding the licence rather than the licence itself.[85] The argument is somewhat tenuous; no buyer would pay for the goodwill of holding a licence, if it could be shown to exist, without a guarantee that the licence also would be transferred. In any case, however, the nexus between licence goodwill, if it exists, and the licence to which it relates suggests both would enjoy similar economic lives.

Payments for the *de facto* transfer of a non-wasting licence either directly or by support for the issue of a replacement licence upon cancellation of the vendor's licence are currently treated as consideration for a non-wasting asset, whether the transaction is recognised as the transfer of a licence or characterised as a payment for the transfer of goodwill. In either case, the deferral of cost recognition until there is an effective disposal of the interest in a non-wasting benefit is an appropriate outcome from a tax policy perspective.

4.4 Non-competition agreements

Genuine personal goodwill, as noted earlier, is inseparable from the owner of a business and cannot be transferred with the business. To ensure that non-transferable goodwill does not shift to a competing enterprise operated by the vendor, the purchaser of a business may seek a non-competition covenant from the vendor.

Non-competition agreements generally do not involve absolute prohibitions of competition but rather restrictions on competition within a fixed geographic location, commonly measured as within a particular distance from the premises of the business being sold. Relying on that connection between the personal agreement and the location of the premises, the Commissioner would often argue that a payment for a non-competition agreement should be treated as consideration for goodwill "connected with" the premises, which would have brought the non-competition agreement into the definition of an assessable lease premium prior to 1952. The argument most often proved to be effective, with the courts agreeing that non-competition benefits could be considered goodwill connected with the premises of the business that was sold.[86]

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83 See Debra Osborn, "Goodwill: much ado about something" (2010 National Resources Tax Conference Paper, Taxation Institute of Australia (WA Division), 25 October 2010); Hung Chu, "A re-evaluation of Murry's case (1998) from a valuation perspective" (2016) 45(3) *Australian Tax Review* 209; Tyrone M Carlin, "Moving beyond Murry – from attraction of custom to everything that adds value" (2018) 46(6) *Australian Business Law Review* 345; Primrose Mroczkowski, "'The cat, the dog, the rat and the rabbit': identifying and valuing 'goodwill' after *FC of T v Murry*" (1999) 2(4) *Journal of Australian Taxation* 212; Michael Inglis, "Trading on goodwill" (2000) 71(3) *Charter* 32; Les Nethercott and Dean Hanlon, "When is goodwill not goodwill? The accounting and taxation implications" (2002) 12(1) *Australian Accounting Review* 55.

84 See *Taxation Ruling* TR 1999/16 (at para 93); Harry Rigney, "Lines of business" (1999) 113(1) *The Australian Banker (Melbourne*) 36.

85 See, for example, Greg Sommers, "Goodwill: the elusive compound" (Victorian State Convention, Taxation Institute of Australia, September 1996).

86 *Berry v FCT* (1953) 89 CLR 653 (vendor of petrol station and subsequent landlord assessed on consideration for non-competition covenant); *FCT v Connolly* (1953) 90 CLR 483 (vendor of shop and newsagency assessed on consideration for non-competition covenant).

As noted earlier, following the commencement of capital gains taxation in 1985, lease premiums were assessable as capital gains, with lessees able to recognise the cost of a so-called premium as a capital loss when the lease expired. The capital gains provisions separately provided for the recognition of payments for non-competition agreements,[87] leaving the Commissioner largely indifferent as to whether business vendors characterised receipts as payments for non-competition agreements or consideration for goodwill connected with real property, except in the early years of the CGT when vendors might claim to be selling goodwill acquired prior to the imposition of the CGT. The measure treating consideration for a non-competition agreement as a capital gain to the grantor and that allowing a beneficiary of the agreement to recognise the cost of the agreement as a capital loss were both transferred from the 1936 Act to the 1997 Act.[88]

The current treatment of explicit non-competition agreements is seriously flawed in tax policy terms, a result of historical legacy and interpretations of capital and revenue concepts developed prior to the inclusion of capital gains in the income tax base. Under present law, a non-competition agreement of a fixed life is treated as a non-wasting capital asset and the cost recovered as a capital loss on expiry of the agreement. From a policy perspective, there are two problems with this rule: the delayed recognition of the expenditure and its characterisation as a capital loss that may not be recognised if the taxpayer does not have an offsetting capital gain. As a result of both factors, the recognition is unconnected with its true nexus with annual income derived by the business over the course of the agreement. A more appropriate treatment would see the cost of acquiring the contractual rights recognised by way of depreciation deductions over the life of the agreement.

5 Recognition rules for the cost of purchased goodwill: experience abroad

As noted earlier, judicial consideration of "goodwill" in Australia in the context of income tax case law has focused on four types of transactions in which a party to the sale of a business has claimed consideration for the purchase of a business included the price of goodwill transferred with the business: mislabelled lease premiums, creation of a notional asset for the purpose of a repo loan, transfers of statutory licences, and the benefits of non-competition agreements entered into by business vendors. Two types of benefit labelled goodwill clearly enjoy limited and wasting lives – goodwill that is actually a lease premium expires with the lease and goodwill that is actually a non-competition agreement lasts only as long as the agreement. The last type of benefit identified in case law – a statutory licence – has an unknown life. Notionally, the licence is indefinite but there is no guarantee that it will be transferred to the new business owner (at best the vendor is selling

87 *Income Tax Assessment Act 1936*, s 160M(6). See further Wouter Scholtz, "Business sales and goodwill: restraints of trade and licences to exploit names and marks" (1995) 7(1) *CCH Journal of Australian Taxation* 6.

88 The consideration received by the grantor is a capital gain under *Income Tax Assessment Act 1997*, s 104-35 (CGT event D1 and the cost recognised as a capital loss to the beneficiary under *Income Tax Assessment Act 1997* s 104-25 (CGT event C2). Pane has argued that a restrictive covenant is simply the contractual arrangement to obtain the benefits of the vendor's goodwill; see Tony Pane, "Branson on goodwill: related assets" (1995) 47 *Butterworths Weekly Tax Bulletin* 751. Arguably the goal of the beneficiary of the agreement is the opposite – to avoid the detriment of the personal goodwill that remains with the vendor. In any case, the legislation treats a non-competition agreement as an asset distinct from purchased goodwill, with cost recognition rules for the former when the agreement expires.

the probability that the licence will be transferred by a State or city when the business is sold) and in theory it can be revoked by the issuing authority at any time for good cause.

Ironically, the one type of goodwill benefit that has not led to litigation and hence is not found in the examples of goodwill set out in the case law is genuine goodwill in the commercial sense. The sale price of a successful business is almost inevitably greater than the market value of the identifiable tangible or intangible assets or rights held by the business. An operating business is endowed with attributes that make it attractive to purchasers who could otherwise simply buy the assets and start a new business. These attributes fall into two groups – the benefits of an existing clientele and the enhanced synergies of assets already in use in a going concern. The value of a profitable business with trained employees, efficient business systems to extract the highest productivity from the assets, an effective administrative infrastructure, and negotiated sales and purchase contracts is inevitably higher than the cost of the assets themselves. The synergies of a successful business in turn create goodwill that attracts ongoing custom attracted to the "brand" of the business.[89]

Separate from actual goodwill and the benefits sometimes mislabelled as goodwill, there are a host of expenses that business might incur for intangible benefits that do not constitute assets such as expenses incurred to protect title to an asset and expenses incurred in attempts to prevent entry into the market of a competitor. All these expenses are considered capital outlays under current judicial tests used to distinguish revenue and capital outlays and all are recognised for tax purposes, often falling into a generic five-year depreciation rule.[90] Expenses to protect title to an asset are capitalised and added to the cost base of the asset. Both responses are questionable from a policy perspective – benefits with known durations should be recognised over their lives and those with no transferable lasting benefit should be deductible as incurred, not amortised over five years or capitalised into the cost base of an asset.[91]

Once actual goodwill is separated from the benefits mislabelled as goodwill, the case for allowing depreciation of goodwill is not difficult to make. The anomalous and multi-faceted nature of goodwill calls for particular attention in the design of an appropriate depreciation regime. Foreign experience may offer some lessons.

89 The Full Federal Court decision in *FCT v Just Jeans Pty Ltd* (1987) 18 ATR 775 provides a useful illustration of the value of a brand name. The taxpayer in the case purported to sell its name and logo to a related party in the course of an audacious, and ultimately unsuccessful, transfer pricing scheme. The Full Federal Court concluded no assets had been sold so no deductions were allowed to the Australian entity for licencing fees to use property that, it had been determined, never existed as severable assets and was thus never transferred. In the course of the Full Federal Court judgment, the court accepted that the value of the name and logo were incorporated in the goodwill of the existing business but noted that it was impossible to sell business goodwill without selling the business. For a detailed discussion of the case and its implications, see Michael Walpole, "Goodwill and taxation issues" (2008) 11(3) *The Tax Specialist* 200. See also Michael W Inglis, "Inglis on CGT" (1995) 66(10) *Charter (Sydney)* 44. Similarly, Andary and Butler have argued part of the consideration paid by a third party for an assignment of a franchisee's interest in the franchise agreement can also be attributed to the transfer of goodwill; see Ramsey Andary and Michael Butler, "Franchise fixings: part 2: goodwill and compliance" (1997) 31(7) *Taxation in Australia* 355.

90 *Income Tax Assessment Act 1997*, s 40-880.

91 This is true, for example, for expenses incurred to protect title to an asset. These were originally regarded as immediately deductible revenue expenses in Australia following the UK precedent established in *Southern v. Borax Consolidated Ltd* (1945) 27 T.C. 103 but following the shift in Australia to the income earning process vs income earning structure test they were regarded as capital expenses – see *John Fairfax & Sons v FCT* (1959) 191 CLR 30. Expenses incurred to defend title to an asset are now included in the cost base of the asset by *Income Tax Assessment Act 1997*, s 110-25(6). Similarly, expenses incurred in an attempt to prevent a competitor from entering the market are currently recognised over five years (see above n 7) but may have no enduring or transferable value.

5.1 Canada

The first Anglo jurisdiction to explicitly allow depreciation for goodwill of all sorts, including customer lists and the value of going concern synergies, was Canada, which provided for depreciation of purchased goodwill from 1972, when it added capital gains to the income tax base. The Canadian rule derived from the landmark Royal Commission tax reform report commonly known as the Carter Report.[92] In addition to the full taxation of realised capital gains, the Carter Report recommended adoption of a broad amortisation regime to cover the costs of acquiring intangible benefits, including goodwill, that were not recognised under existing rules – "nothings" as Canadian tax practitioners called the expenses or "black hole" expenses in Australian terminology.

The measure enacted followed the broad outline of that recommended in the Carter Report, applying in a residual fashion to a broad array of not otherwise recognised expenditures for intangible benefits and assets. A single pool was used with the cost of purchases added to the pool and proceeds of disposal subtracted from the pool. The year end balance was depreciated on a 10% declining balance basis.

Political compromises along the way to enactment of Carter Commission's proposals led to a half inclusion of capital gains in the income tax base. The intangible benefit amortisation regime adopted reflected the partial inclusion of gains and, accordingly only 50% of the cost of acquisition was recognised.

When the capital gains inclusion rate was raised to 75% in 1990, the portion of the cost base that could be depreciated was also raised to the same percentage but the depreciation rate declined to 7%. Depreciation for 75% of the cost of intangibles with uncertain lives was retained when the inclusion rate for capital gains was reduced to 66.6% in 2000 and further to 50% of the gains later that year. A revision and simplification of the depreciation rules led to the adoption in 2017 of a consolidated capital cost allowance pool for intangibles that provides for a 5% declining balance deduction for the full cost of acquisition of the intangible benefits.[93]

5.2 United States

The difficulty of determining an effective life of a composite asset such as a customer list is well illustrated in early case law of the US, the only Anglo jurisdiction that has always allowed full depreciation for all intangible benefits (apart from "goodwill") based on a general rule that allowed depreciation deductions for the cost of any wasting asset.[94] In

92 Royal Commission on Taxation (Kenneth LeM Carter, chair), *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer and Controller of Stationery, 1967) (Carter Commission).

93 Income Tax Regulations (C.R.C., c. 945) sch II (Capital Cost Allowance CLASS 14.1), specifically including "goodwill" in the class. The general definition of property in the Act includes "goodwill" (*Income Tax Act* (s 248(1)) and operative provisions such as the balancing charge (recaptured depreciation) measure also include goodwill (*Income Tax Act*, s 13(34)).

94 [US] *Internal Revenue Code* §167.

Johnson v United States,[95] for example, the depreciation schedule for the cost of acquiring a gynaecology practice was determined considering compelling evidence presented by the taxpayer of factors such as the likelihood of younger patients becoming pregnant and delivering babies within a limited period of time, the likelihood of older women contracting various ailments, and the transient nature of the population in an oil town with employees of a mining company and their families regularly transferred.

The US rule, allowing depreciation for any identified wasting intangible benefit apart from goodwill led to undesirable hurdles for taxpayers acquiring benefits of this sort, requiring taxpayers to recast goodwill as specific wasting benefits and then establish realistic lives for the elements of each benefit. The resulting deadweight costs for both taxpayers and tax administrators eventually prompted a rethink of the nature of goodwill and 21 years after Canada adopted a depreciation regime for goodwill, the US followed in 1993, albeit with a slightly different design, a straight-line basis 15-year life regime. Operating as an alternative to the general depreciation rule, the system for intangible benefits allowed taxpayers to avoid the costly and complex calculation of the likely life of operating concern benefits such as customer lists.

5.3 United Kingdom

The UK was the third Anglo jurisdiction to adopt a depreciation regime for purchased goodwill. Prior to 2002, the UK treated goodwill as a capital asset with losses (and gains) recognised under the capital gains regime. This created a problem similar to that in Australia where losses from full depreciated goodwill could only be offset against realised capital gains, not against the income generated by use of the goodwill. In 2002 the UK shifted to allow depreciation of purchased goodwill, assuming a 25-year life for the asset. Depreciation was removed in 2015 with a goal of equalising the position of a taxpayer who bought a business from a corporate owner and the taxpayer who simply bought the company operating the business. Recognition reverted to the pre-2002 system with recognition of expenses only when there was a disposal of the asset but the post-2015 rule avoided the problem with limited recognition of capital losses by treating the loss on disposal of goodwill as an ordinary business loss.[96] It was recognised, however, that the conceptually preferable treatment was to allow amortisation and this was reintroduced in 2019, with the second iteration allowing a write-off in just over 15 years (an annual depreciation rate of 6.5%).[97] The current depreciation rule ties the goodwill deductions to parallel acquisitions of separately identifiable intellectual property, capping the value of depreciable acquired goodwill at six times the value of the separately identifiable intellectual property acquired.[98]

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95 *Johnson v United States*, 1961 US Dist. Lexis 5460; 61-1 US Tax Cas. (CCH) P9278; 7 A.F.T.R.2d (RIA) 793. See *Ithaca Indus v Commissioner*, 97 T.C. 253 (the aggregate of renegotiable supply contracts was amortisable upon establishment of a reasonable approximation of the useful life, though assembled workforce was a fluctuating non-wasting asset with no ascertainable useful life) and *Newark Morning Ledger Co v United States*, 507 US 546 (purchase consideration allocated to “paid subscribers” was amortisable by establishing a finite number of subscriptions each of which has a limited useful life). See also Mitchell L Engler, “Goodwill hunting gone bad: tax law’s outmoded treatment of goodwill” (2018) 96(4) *Nebraska Law Review* 883.

96 *Corporation Tax Act 2009* (UK), s 816A(4) (debit in respect of goodwill is a non-trading debit); s 753(1) (non-trading losses set off against business profits).

97 *Corporation Tax Act 2009* (UK), s 879B. Goodwill has the same meaning as in accounting (*Corporation Tax Act 2009* (UK), s 715, as amended by *Finance Act 2019* (UK) sch 9, s 3).

98 Identifiable intellectual property includes patents, registered designs, copyright and design rights and plant breeders’ rights.

6 Recognition rules for the cost of purchased goodwill in Australia

From 1996 until 2004, Australian accounting rules allowed taxpayers to amortise the cost of acquired goodwill on a straight-line basis over an estimated life of up to 20 years.[99] This was replaced, following the change of international accounting standards in 2004, with a rule that treated goodwill as a non-wasting asset that can be partially expensed against revenues to the extent the taxpayer can show the value of the goodwill had been "impaired" or declined in value during the year. Impairment was measured as an identified decline in the value of the goodwill, an unlikely outcome if the business continues and continually modernises and adjusts as needed to maintain its market presence.[100] The appropriateness of the current rule is now under review.

One consideration behind the current accounting rule may be the uncertainty regarding the lifespan or rate of diminution in value over time generally of the synergy and operational benefits of an ongoing concern. It may, however, be possible to measure the decline in value of some specific elements such as an existing client base or customer list using historic and actuarial values and based on those calculations allow the purchaser of a business whose value largely consists of the existing customer list to amortise the cost of the customer list over its life as the US experience described above illustrates. The challenge is to determine the life of a list where each person on the list has characteristics different from every other person on the list.

Recognising the wasting nature of goodwill for tax purposes was considered in the late 1990s by the Ralph Review. The Review noted that depreciation of purchased goodwill was widespread among Organisation for Economic Co-operation and Development (OECD) countries surveyed, describing four of the countries studied, the UK, Mexico, New Zealand and Australia, as exceptions to the rule. The UK subsequently reintroduced depreciation of goodwill.[101] However, a research paper issued by the Review prior to the final report suggested it could be seen as anomalous if goodwill gains were recognised on a realisation basis while depreciation was allowed annually[102] and the Review's final report recommended no depreciation be allowed for purchased goodwill.[103]

The tenuous logic of the Review's recommendation suggests that another motivation might better explain the decision but the actual reason remains unclear. The Australian tax system generally allows recognition of the cost of wasting assets over their estimated lives and, if it turns out the assets actually unexpectedly appreciate in value, recognises the gain when it is realised and known. Tax policy principles suggest similar treatment of goodwill is appropriate.[104] Any "gain" on a later sale of goodwill is more likely attributable to later created goodwill than originally purchased goodwill. It is possible the apparently anomalous Ralph Review recommendation holds an unacknowledged link to the generous concession recommended for gains on the sale of small business assets on top of a

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99 Australian Accounting Standard AASB 1013, *Accounting for Goodwill* (1996), para 5.2.

100 Australian Accounting Standard AASB 136, *Impairment of Assets* (2004), para 10(b).

101 Review of Business Taxation (John Ralph, chair), *Taxation of business income: an international perspective* (1998), pp 44-47.

102 Review of Business Taxation (John Ralph, chair), *A platform for consultation* (1999), p 129, para 420.

103 Review of Business Taxation, above n 72, p 322, para 822.

104 A brief but very clear articulation of the logic of depreciating goodwill is set out in Keith James, "The dilemma over goodwill as a taxable asset" (1993) 6(3) *New Accountant* 8.

generous half exemption for all capital gains, effectively exempting 75% of the gains on sales of goodwill.

Whatever the basis for the Ralph Review's view that Australia should not follow the trend in other Anglo countries and beyond, in a benchmark neutral income tax, the portion of the cost of purchasing an ongoing concern attributable to business synergy goodwill would be recognised as the price of a wasting asset used to generate ongoing business and deductible over an estimated lifetime.

Two preliminary questions must be resolved if depreciation for goodwill were to be allowed. The first is how goodwill eligible for depreciation should be defined and the second is whether a depreciation regime for goodwill should take into account the concessions for gains realised on the sale of goodwill.

6.1 Defining goodwill for a goodwill depreciation regime

To gain tax benefits, first in relation to stamp duties and later in the context of the income tax, taxpayers have, more often than not unsuccessfully, sought to label many attributes of businesses or business transactions as goodwill. Courts, often in obiter discussion on the fringes of taxpayers' mischaracterisations, revealed a far more sophisticated understanding of true goodwill, the synergies and characteristics of a business that increase the value of the going concern over the sum of separate values of its component parts, identifying aspects such as "name" goodwill and "monopoly" goodwill.[105] As often as not, the "goodwill" value of a business in excess of the market value of its assets if sold separately is attributable not to factors that can increase *gross revenue* (that is, attract customers), but rather the factors that increase *net profit* (that is, extract greater profits from the business assets).[106]

The target of any depreciation regime for goodwill is goodwill in its commercial sense – the benefit taxpayers acquire in the course of buying an operating business. These are benefits that diminish in value over time as new investment and operational elements of the business replace and hopefully enhance the value of the going concern. While goodwill has never been defined for Australian income tax purposes, a definition would be necessary if the intention was to limit a new depreciation regime to this type of goodwill. The definition could draw on overseas precedents, defining goodwill, for example, in terms of the elements of depreciable intangible property in the US including "going concern value", "workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment" and "business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers)".[107]

Alternatively, the law could simply refer to the undefined concept "goodwill" in the same manner as the former capital gains concession. It might be argued that allowing depreciation for goodwill but leaving the term undefined would invite business purchasers to recharacterise payments for other business attributes such as lease premiums and non-competition agreements as goodwill in contracts for the sale and purchase of a business. Arguably, however, this would not be an onerous outcome in tax policy terms.

105 See Hill, J in the Full Federal Court judgment in *FCT v Krakos Investments Pty Ltd*, above n 3.

106 The relationship between the two types of goodwill is clearly set out with helpful examples in Hung Chu and Wayne Lonergan, "A rethink of goodwill" (2010) 39(1) *Australian Tax Review* 7.

107 [US] *Internal Revenue Code* §197(b)(1).

The current recognition rule for the cost of assets such as lease premiums or limited life non-competition agreements (treating them as capital losses on the expiry of the agreement) is simply an outcome of the haphazard development of the Australian depreciation system. In a benchmark income tax regime, the cost of such agreements would be recognised over their life. The very real possibility that taxpayers would attempt to relabel premiums and payments for non-competition agreements as consideration for depreciable goodwill could be an effective way to address the shortcomings in the current law in terms of recognising over time these types of expenses. It would, admittedly, be very rough justice compared to the benchmark treatment of fixed depreciation over the life of a lease or non-competition agreement if the goodwill depreciation period were substantially longer than the lease or non-competition agreement but at the same time it would achieve a substantial improvement over current law in a simple manner.

A possible concern with a depreciation regime for undefined goodwill is the risk that taxpayers would also seek to label consideration in sales agreements for the transfer of statutory licences such as taxi licences or hotel licences and unrealised gains as the price of transferred goodwill. Overseas experience in the US, the UK and Canada, all of which allow depreciation of goodwill that might encompass these amounts, suggests the problem is not at all serious. While statutory licences may have no fixed expiry date, the reality is they are sometimes cancelled or otherwise not transferred on the disposal of a business. Their value often diminishes as the economy evolves, as the impact of Uber on the value of taxi licences illustrates. It is not costly to give the taxpayer the benefit of the doubt with so-called perpetual licences.

Another possible risk is the mislabelling of unrealised gains on tangible assets as goodwill on the sale of a business. The vendor seeking to avoid balancing charges on over-depreciated plant and equipment or recognition of unrealised gains on non-depreciated assets may seek to transfer both at their book value on the sale of a business, labelling the excess sale price as consideration for goodwill. This risk, however, will be offset by the purchaser's interest in transferring depreciable property at the true market value to increase the cost for depreciation purposes and raise the cost base for capital gains purposes.

The definitions of depreciable goodwill in the UK, the US and Canadian depreciation regimes do not exclude the possibility of taxpayers treating payments for statutory licences and the value of unrealised gains as consideration for goodwill. The systems simply conclude the countervailing interests of parties in arm's length transactions will yield an acceptable outcome, an approach that avoids the obvious difficulty of defining goodwill. If Australia were to accept the fact that goodwill should be depreciable for tax purposes, the regime could be adopted without a statutory definition of the concept.[108]

6.2 Aligning goodwill depreciation and capital gains concessions

A question that clouds the logic of allowing depreciation for goodwill is the concessional treatment of gains on the sale of goodwill, including outright exemption in many cases. At least one precedent, the post-Carter Canadian reforms that included depreciation of purchased goodwill, was premised on an assumption that there should be a link between the recognition of cost for goodwill depreciation purposes and the concessional recognition of gains in the capital gains tax regime. Originally, the 50% inclusion of capital gains was

108 Walpole suggested a statutory definition of goodwill used in the definition of a CGT asset would introduce more "certainty" to the income tax law: Walpole, "Goodwill and taxation issues", above n 89, at 229. As noted, this may not be needed if the only reference to goodwill were in a depreciation rule for that benefit.

matched by depreciation of only half the cost of goodwill. The link remained when the inclusion rate rose to 75% of the gain, but was modified when the inclusion rate of gains fell, in two steps, to 50% again and while the depreciation rules continued to recognise 75% of the cost. In contrast, the US system makes no attempt to link depreciation of goodwill to the concessional treatment generally of capital gains, allowing taxpayers to depreciate the full cost of eligible property while providing a concession, formerly a partial exemption as in Australia and currently a preferential tax rate, for gains.

Australian tax law in general also severs the rules for depreciation of cost from the concessional treatment of gains. Prior to 1985, capital gains were untaxed but the full cost of eligible assets was recognised for depreciation purposes. The dichotomy was retained when capital gains taxation was adopted from 1985, with full depreciation of the cost of tangible assets but indexation of gains in the capital gains regime, changed in 2000 to a 50% exemption for capital gains.

Prior to 2001, the dichotomy between full recognition of the cost of depreciable assets and concessional treatment of capital gains applied not only generally but also to individual depreciable assets. While the cost of depreciable property was fully recognised, gains on the sale of depreciable assets in excess of recapture of depreciation to the original cost (the "balancing charge") were exempt from tax prior to 1985, eligible for the cost indexation rule from 1985 to 1999, and the 50% capital gains exemption from 1999. In 2001, the balancing charge regime was extended to the full termination value of depreciable property, removing the concessional treatment and instead treating any capital gain realised on the disposal as fully taxable statutory income.[109]

No explicit policy explanation was offered in Canada when a limitation was placed on the depreciation of goodwill linked to the concession for capital gains. The depreciation rule was only one element in a comprehensive overhaul of the tax rules for capital gains and recognition of the cost of capital assets and the parallel treatment appeared logical to policy makers who were simultaneously expanding the base with the inclusion of capital gains and widening recognition of cost with the goodwill depreciation rule. Arguably, however, any policy rationale behind the linkage between concessional treatment of gains and limited recognition of cost is particularly attenuated in respect of goodwill. While one might question the soundness of the political decision to tax (or exempt from tax) capital gains on a concessional basis, these gains are wholly separate from the cost of goodwill. Recognition of the cost of that goodwill is desirable so long as the business income it generated for the business owner is taxable. The concessions for goodwill realised on the sale of a small business are irrelevant to the correct measurement of income prior to sale, a calculation that should take into account the diminution in value of purchased going concern goodwill.

6.3 Designing a goodwill depreciation regime for Australia

Unlike many of the benefits or arrangements that may be mislabelled as goodwill by taxpayers such as lease premiums or non-competition agreements with fixed and known lives, the longevity of purchased goodwill, while limited, is inherently uncertain. Use of a single expected life for transferred goodwill is almost certain to be incorrect in any given case, although it may be possible to find a rate close to the mean, providing rough justice

109 *Income Tax Assessment Act 1997*, s 40-285, with the gain disregarded for capital gains purposes under s 118-24.

for purchasers of businesses carrying a goodwill premium. A presumed 15 year life is common in jurisdictions that allow depreciation for tax purposes of purchased goodwill,[110] although there are examples of shorter[111] and longer[112] periods. The most prevalent choice would be a logical starting point for desigining an Australian rule.

Most commonly, depreciation of purchased goodwill is allowed on a straight-line basis that presumes the benefits acquired diminish in value equally over the presumed life. A straight-line system is currently used in Australia for the cost of acquiring or creating registered intellectual property. The most significant departure from the straight-line depreciation system is the declining balance system used in Canada, a jurisdiction that, on its face, appears to be an outlier in this respect in terms of recognition systems. When considered in the context of current business reality, the Canadian system may not be as anomalous as it appears, however. Straight-line rules were adopted in an era of relative commercial stability, prior to the age of disruption and almost continual turmoil in the market from digital innovations. In the current commercial environment, it is highly probable that the value of purchased goodwill will recede in a declining balance manner, with larger losses in value initially, gradually tapering off as residual benefits recede.

It may not be necessary to determine which of these two recognition timing systems is best used to recognise the cost of purchased goodwill. With only a few exceptions (including expenditures for buildings, intellectual property, and rural telephone and electricity lines), depreciable outgoings can be recognised at the election of a taxpayer on either a straight-line or declining balance basis. A similar election could be made available to taxpayers if depreciation is allowed for goodwill.[113]

While expansion of the depreciation system to include the cost of purchased goodwill could be accomplished as a stand-alone initiative, a broader reform could also be contemplated, using the opportunity to provide straight-line depreciation for the cost of intangible assets with fixed and known lives such as lease premiums and contracts including non-competition agreements. If policy-makers conclude this is too ambitious in the current environment, a fall-back approach would be to roll these expenditures along with goodwill into a pool similar to that used in Canada. It would truly be a second-best solution, given the fact that accurate depreciation is easy to implement if the exact life of an asset is known at the time of acquisition. It would nevertheless be an improvement on the current system if the first-best solution is politically out of reach.

7 Conclusion

Few areas of income tax law have been as unsettled for so long as the meaning of goodwill and its treatment under a variety of income tax rules. The confusion has been enhanced by the tendency of taxpayers to characterise a wide range of benefits as "goodwill" to exploit exemptions and concessions for gains on the disposal of goodwill or of assets defined to include goodwill. An examination of litigation concerning the application of income tax provisions to transactions involving transfers, or purported transfers, of goodwill reveals

110 This is used, for example, in the US, the UK, Austria, and Germany.

111 Denmark, for example, uses 7 years and the Netherlands uses a 10 year life; Belgium allows depreciation over as low as 5 years or 10 years if the goodwill is based on client lists.

112 Italy, for example, uses an 18 year life.

113 A 15-year straight-line life is the counterpart of a 13% declining value rate, using the conversion factor that has applied to wasting assets since 2006: *Income Tax Assessment Act 1997* s 40-70.

four types of arrangements that either the Commissioner or taxpayer asserted involved a sale of goodwill. In two cases – where payments for "goodwill" were actually payments for lease premiums or non-competition agreements – the benefits had limited lives and the payments, currently recognised as capital losses on expiry of the lease or agreement, would be amortised over the life of the benefit in a benchmark income tax. So, too, in theory, would payments for the elements that comprise commercial goodwill such as customer lists and business synergies, though ascertainment of the actual lives of these benefits would be problematic in the extreme.

An admittedly rough justice outcome could be achieved with a depreciation rule for goodwill, using a 15-year presumed life and offering taxpayers the option available for acquisition of most types of depreciable assets, calculating depreciation using straight-line or declining balance methodology. The rule would, to be sure, be a surrogate only for accurate tracing of the economic decline of different types of goodwill, but this is to some extent true for any other tangible or intangible assets. The balancing charge mechanism used to recapture excess depreciation and refund inadequate depreciation is recognition of the rough and ready surrogate nature of any depreciation regime with a prescribed deduction schedule or formula.

The model reform would see depreciation for goodwill matched by a shift of recognition rules for the cost of fixed-life contracts from capital losses when the contracts expire to amortisation over their lives. A second-best solution would be one depreciation rule for all intangible assets not currently subject to amortisation. The most efficient way of dealing with these varied expenditures would be a declining balance pool similar to that used in Canada. Including all goodwill expenditures in a single pool can mitigate some inaccuracies by automatically offsetting cases of accelerated depreciation and retarded depreciation while accommodating continual new purchases.

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