TR 98/D13 - Income tax: capital gains: goodwill of a business

Draft Taxation Ruling
Income tax: capital gains: goodwill of a business

other Rulings on this topic

IT 2328; IT 2540; TR 92/20; TR 94/D41; TR 95/3; TR 95/31; TR 98/3

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What this Ruling is about

Class of person/arrangement

1. This Ruling explains how the provisions of Part 3-1 of the *Income Tax Assessment Act 1997* (the 1997 Act) - the capital gains and losses: general topics provisions - apply to a taxpayer who conducts a business with goodwill and who makes a capital gain or loss if a CGT event happens to goodwill of a business. It also explains how the partial exemption in section 118-250 applies if on:

(a) a change in the ownership of a business (below the business exemption threshold), or an interest in it; or

(b) an ending of a business or of an interest in it

a taxpayer makes a capital gain attributable to the goodwill of the business.

2. The Ruling also applies to a disposal of goodwill, or an interest in goodwill, under the *Income Tax Assessment Act 1936* (the 1936 Act), on the disposal of a business or an interest in a business before the 1998-99 income year.

3. The Ruling considers the following general issues:

(a) what 'goodwill' means for the purposes of the definition of 'CGT asset' in section 108-5 including the following specific issues:

- are so-called 'site goodwill', 'personal goodwill' and 'name goodwill' separate CGT assets in their own right for the purposes of Part 3-1?

- what are the consequences of goodwill of a business being one CGT asset?
- on a disposal of one of several businesses or on a disposal of something less than a business, is there a disposal of goodwill for the purposes of section 118-250?
- on an expansion of an existing business or on a commencement or acquisition of a new business, is new goodwill acquired?
- what is the relationship between goodwill of a business and other assets of the business?
- what is the relationship between goodwill of a business and the 'get-up' of the business (that is, how it is presented using such things as its name, logos, slogans, symbols, signs, colour schemes and visual images) or knowledge or information used in the business?
- what is the relationship between a restrictive covenant and goodwill?
- does work in progress form part of the goodwill of a professional business?

(b) the operation of the goodwill concession in section 118-250;

(c) the measurement and valuation of goodwill, particularly for the purposes of the part exemption in section 118-250, the small business roll-over provisions of Division 17A in Part IIIA of the 1936 Act and the small business retirement exemption provisions of Division 17B in Part IIIA of the 1936 Act;

(d) when goodwill is acquired;

(e) the cost base of goodwill;

(f) the transferability of so-called 'personal goodwill';

(g) the CGT consequences in relation to goodwill when a business ceases; and

(h) whether a change occurs in the ownership of a business, or an interest in it, for the purposes of section 118-250 if part of a business is disposed of.

4. This Ruling reflects the decision of the High Court of Australia in *FC of T v. Murry* 98 ATC 4585; (1998) 39 ATR 129. The law in dispute in the *Murry* case was the 1936 Act rather than the 1997 Act.

Subject to that difference, the majority justices in the *Murry* case expressed views relevant to all of the general issues in paragraph 3 of this Ruling except the issues in subparagraphs 3(g) and 3(h).

5. This Ruling does not consider specific goodwill issues that arise in or from particular industries or business operations (for example, property management rights and franchises). Separate Taxation Rulings addressing these specific issues will be issued in due course.

Cross reference table of provisions

6. In this Ruling, a reference to a provision in the 1997 Act can be read, as appropriate, as a reference to the equivalent provision in the 1936 Act. The following table provides cross references between the relevant provisions of the 1997 Act and the corresponding provisions in the 1936 Act:

1997 Act	1936 Act
Part 3-1	Part IIIA
section 6-5	subsection 25(1)
section 102-20	subsection 160Z(1)
subsection 104-10(5)	subsection 160L(1)
section 104-20	section 160N
section 104-25	paragraph 160M(3)(b)
section 104-35	subsection 160M(6)
section 108-5	section 160A
section 108-70	section 160P
section 109-5	sections 160M, 160U
section 109-10, item 1	paragraph 160M(5)(b), subsection 160U(5)
section 110-25	subsection 160ZH(1)
section 116-25	subsection 160ZD(2B)
section 116-30	subsection 160ZD(2)
section 116-40	subsection 160ZD(4)
section 118-20	subsections 160ZA(4) to (7)
section 118-250	section 160ZZR
Division 149	section 160ZZS
section 165-210	section 80E
subsection 995-1(1)	subsection 6(1)

Ruling

Meaning of 'business'

7. For the purposes of this Ruling, the word 'business' in its context in section 118-250 has its ordinary meaning. It is a course of conduct carried on for the purpose of profit and also involves notions of continuity and repetition of actions. It is an undertaking or going concern in which an entity or entities use assets, knowledge, skills, human resources and other things as required in continuing activities or transactions for commercial purposes. A business is not a thing or a series of things. A business is not a CGT asset.

8. The expansive definition of 'business' in subsection 995-1(1), which 'includes any profession, trade, employment, vocation or calling, but does not include occupation as an employee' is only

relevant in this Ruling to the extent that the carrying on of a 'trade' or a 'profession' may be a 'business' in the ordinary sense of the word.

Meaning of 'goodwill'

9. 'Goodwill' for the purposes of the definition of 'CGT asset' in section 108-5 has the meaning it bears under the general law. It is the legal definition of goodwill as explained by the High Court in the *Murry* case, rather than its accounting and business definitions, which applies.

10. As explained more fully at paragraph 84 of this Ruling, goodwill is the product of combining and using the tangible, intangible and human assets of a business for such purposes and in such ways that custom is drawn to it. Goodwill is a quality or attribute that derives from using or applying other assets of a business. It may be site, personality, service, price or habit that obtains custom. It is more accurate to refer to goodwill as having sources than it is to refer to it as being composed of elements. Goodwill is a composite thing. It is one whole. It is an indivisible item of property that is legally distinct from the sources from which it emanates. It is something that attaches to a business and is inseparable from the conduct of a business. It cannot be dealt with separately from the business with which it is associated.

11. What goodwill means depends on the character and nature of the business to which it is attached. Goodwill differs in its composition in different trades or industries and in different businesses in the same trade or industry. One or more sources of goodwill may preponderate in one business and another source or sources may be prominent in another business.

12. Goodwill is not a series of CGT assets that inhere in other identifiable assets of a business. Goodwill, being a composite thing, attaches to the whole business. It does not attach separately to each identifiable asset of the business. Nor is there an element of goodwill in each identifiable asset of a business.

13. Goodwill is a species of intangible property. It can only exist in connection with the conduct of a business, even though it may not necessarily appear in the books of account and financial statements of the business.

Are so-called 'site goodwill', 'personal goodwill' and 'name goodwill' separate CGT assets in their own right for the purposes of Part 3-1?

14. No. Goodwill is a single CGT asset for the purposes of Part 3-1.

What are the consequences of goodwill of a business being one CGT asset?

Goodwill remains a single CGT asset if the same business continues

15. The whole of the goodwill of a business that commenced before 20 September 1985 remains the same single pre-CGT asset (subject to Division 149 - about when an asset stops being a pre-CGT asset - see paragraph 89) provided the same business continues to be carried on. This is so even though:

(a) the sources of the goodwill of a business may vary during the life of the business; or

(b) there are fluctuations to the goodwill during the life of the business.

Can a business change to such an extent that it is no longer the same business and its goodwill becomes a new asset?

16. A business or the sources of its goodwill may change so much it can no longer be said to be the same business as that previously conducted. If it becomes a different business, the goodwill becomes a different CGT asset.

17. Whether the same business is being carried on is a question of fact and degree that ultimately depends on the circumstances of each particular case. The test to use for whether the same business is being carried on is not the same test as that described in paragraphs 9 and 10 of Taxation Ruling TR 95/31 for continuity of business in applying the tax loss provisions in subsection 165-210(1) (paragraph 80E(1)(b) of the 1936 Act).

18. The business does not need to be identical from its acquisition to its disposal. If the essential nature or character of the business is not changed, the business remains the same business for the CGT goodwill provisions. A business owner may expand or contract activities, or change the way in which a business is carried on, without ceasing to carry on the same business provided the business retains its essential nature or character. Organic growth or diversification of a business by:

(a) adopting new compatible operations;

(b) servicing different clients; or

(c) offering improved products or services

does not of itself cause it to be a different business provided the business retains its essential nature or character .

19. Nor would it be a different business if all that happens is that portions of the operations of a business are discarded in an ordinary commercial way but the business retains its essential nature or character.

20. If the types of customers a business attracts change as the business evolves over the years, this does not necessarily mean the business is no longer the same business as was originally carried on.

21. It is not sufficient, however, if just a similar kind of business is carried on. It must be a business of the same essential nature or character that is carried on. The same business is not carried on if:

(a) through a planned or systematic process of change within a reasonable period of time, a business changes its essential nature or character; or

(b) there is a sudden and dramatic change in the business brought about by either the acquisition or the shedding of activities on a considerable scale.

Goodwill, as a whole, is either a pre-CGT asset or a post-CGT asset

22. The whole of the goodwill of a business is either pre-CGT goodwill (subject to Division 149 - about when an asset stops being a pre-CGT asset - see paragraph 89) or post-CGT goodwill. The goodwill of a particular business cannot be characterised as partly pre-CGT goodwill and partly post-CGT goodwill.

On a disposal of one of several businesses or on a disposal of something less than a business, is there a disposal of goodwill for the purposes of section 118-250?

23. A disposal of the goodwill of a business (that is, a CGT event A1), on a disposal of the business, entails the disposal of the entire goodwill.

24. If a business owner is carrying on business operations at one or at several locations or countries and part of the business operations is sold, questions arise whether:

(a) several businesses are carried on; or

(b) one business is carried on;

and whether what is sold is:

(c) an entire, self-contained business that a purchaser could conduct without more; or

(d) something less than a business.

25. If a business owner is carrying on more than one business, each business has its own separate goodwill and each business may be disposed of along with the goodwill attaching to it. Section 118-250 applies (subject to the business exemption threshold being met).

26. If a business owner is carrying on one business and disposes of some part of the business operations, it is a question of fact whether the owner has disposed of a discrete business that a purchaser could conduct without more or has merely disposed of a business asset or a collection of business assets. This question is determined having regard to all of the circumstances including whether sufficient assets are sold to enable the purchaser to carry on the business as the vendor had carried it on, whether the assets sold are accompanied or carry with them the legal right or privilege to conduct a business and whether the operation is sold as a self contained business.

27. A change in the ownership of a part of a business can occur when that part is separate and severable from the rest of the business, either geographically or by reference to the products or services, or in some other way.

28. If the operations sold constitute a discrete business, the sale includes a disposal of goodwill.

29. A disposal of a business operation that does not constitute a discrete business in its own right is merely a disposal of an asset or a collection of assets of a business with no goodwill. It does not satisfy the requirements of section 118-250. The sale of an asset or a series of assets separate from the business itself does not involve any disposal of the goodwill of the business. For goodwill to be disposed of, there must be a business disposed of to which the goodwill may attach.

30. In the end, the vital consideration is whether the effect of the transaction is to put the purchaser in possession of a going concern the activities of which the purchaser could carry on without interruption.

31. Many factors are relevant to this decision though few are conclusive in themselves. If there is a continuation of the conduct of a business from vendor to purchaser, this points to a business having been transferred rather than a transfer of a business asset or a collection of business assets. The converse is not, however, necessarily true because a transfer of a business may be complete even though the purchaser does not choose to avail themself of all the rights they acquire. Similarly, an express assignment of goodwill is strong evidence of a transfer of the business to which it is attached if what the purchaser acquired was a going concern. The absence of an express assignment of goodwill is not conclusive if the vendor has effectively deprived themself of the power to compete. The absence of an assignment of business premises, trading stock or outstanding

contracts is likewise not conclusive if the particular circumstances of the purchaser nevertheless enable them to carry on substantially the same business previously carried on by the vendor. It is not a conclusive factor whether the vendor continues to carry on business at other locations but a disposal of business activities conducted at one geographical location separate from those conducted at other locations is a relevant factor in determining whether what was sold was a discrete business in its own right.

On an expansion of an existing business or on a commencement or acquisition of a new business, is new goodwill acquired?

Internally generated goodwill

32. If a new business operation or activity introduced by a taxpayer is an expansion of an existing business (whether it commenced before or after 20 September 1985), any goodwill built up in conducting the expanded business is merely an expansion of the existing goodwill of the business. If a business which commenced before 20 September 1985 (a 'pre-CGT business') is expanded, goodwill generated in conducting the expanded business is merely an accretion to the pre-CGT goodwill.

33. If an introduced business activity is a new business, the goodwill attaching to that business is a new asset separate from the goodwill of the existing business.

34. Whether an increase in business operations or in the scale of activity constitutes an expansion of an existing business, or a new and separate business in its own right, is a question of fact dependent on the circumstances of each particular case. Factors that need to be considered in determining whether the business operation or activity is part of the existing business or is a new business include the nature of the new business operation or activity, the types of customers that the business operation or activity attracts and the extent to which the business operation or activity:

(a) is subject to the same integrated management and control as the existing business;

(b) is treated for banking and accounting purposes as an extension of the existing business or as a separate business;

(c) uses one or more different trading names; and

(d) is related to or dependent on the existing business in a practical, economic or commercial sense.

Purchased goodwill

35. If a taxpayer who founded or purchased a business adds to that business an additional business purchased as a going concern, it is question of fact dependent on the circumstances of each particular case whether the additional business is subsumed into and forms part of the existing business or whether the two businesses remain as separate businesses.

36. For example, if one of the businesses was a pre-CGT business and the two businesses are combined into one without the pre-CGT business losing its essential nature or character, the goodwill of the post-CGT business is subsumed into the goodwill of the pre-CGT business and all of the goodwill of the business is taken to have been acquired before 20 September 1985. The pre-CGT business must not lose its essential nature or character in the sense that it must remain the same business and not be overwhelmed by the post-CGT business in such a way that it has become a different business. The purchase of the post-CGT business must involve merely organic growth of the pre-CGT business or an accretion to it in reasonable proportions or it gives rise to a new, different business and its goodwill is a new asset.

37. If a taxpayer operating a pre-CGT supermarket acquired a bakery outlet after 19 September 1985 and - as a matter of fact - integrated it with the supermarket in one consolidated business and later sold the consolidated business at a gain, the whole of the amount received for the goodwill of the integrated business is taken to have been acquired before 20 September 1985 (subject to Division 149 - about when an asset stops being a pre-CGT asset - see paragraph 89). Paragraphs 2 to 6 of Taxation Ruling IT 2328, when this draft Ruling is finalised, will be withdrawn.

38. If, on the other hand, the two businesses (for example, the supermarket and the bakery outlet) are - as a matter of fact - separate and distinct businesses, the goodwill attached to the additional business is acquired after 19 September 1985.

39. Any accretion to the goodwill of a business does not constitute a capital 'improvement' to the goodwill of the business for the purposes of section 108-70 - about when a capital improvement is a separate asset - and is not taken to be a separate CGT asset.

What is the relationship between goodwill of a business and other assets of the business?

40. Goodwill is one CGT asset separate and distinct from other assets of the business such as plant, licences (whether exclusive or non-exclusive licences), statutory permits, quotas, entitlements,

contractual rights and items of intellectual property (for example, a trade mark, patent, copyright or registered design).

What is the relationship between goodwill of a business and the get-up of the business or knowledge or information used in the business?

41. The get-up of a business - including its business or trade name, its logos, slogans, symbols, signs, colour schemes and visual images - is a source of goodwill and is not in itself goodwill.

42. Scientific, technical, industrial or commercial knowledge or information (such as know-how, mining, quarrying or prospecting information, a trade secret, secret process or formula) is also not goodwill.

43. Goodwill does not attach to assets of a business or to knowledge or information. Rather, it attaches to the business that uses the assets, knowledge or information. Proceeds of the sale of a business are reasonably attributed to the goodwill of the business and to the assets, knowledge or information.

What is the relationship between a restrictive covenant and goodwill?

44. If on a sale of a business a restrictive covenant is entered into, the restrictive covenant is a CGT asset separate in its own right from the goodwill.

45. A restrictive covenant given by a vendor of a business or by an employee of the vendor is inextricably linked to the value of any goodwill disposed of. If a vendor and purchaser dealing at arm's length do not allocate a specific part of the sale proceeds in the contract of sale to the covenant, for Part 3-1 purposes we will treat the giving of the covenant as being ancillary to the disposal of the goodwill of the business and no part of the proceeds need be attributed to the grant of the restrictive covenant.

46. If a vendor and purchaser allocate separate parts of the sale proceeds in the contract of sale to the granting of the restrictive covenant and to the disposal of the goodwill, we will accept the proceeds so allocated provided the parties dealt with each other at arm's length in reaching their agreement.

47. Any contrary views expressed in Taxation Ruling TR 95/3 are to be withdrawn when this draft Ruling is finalised.

48. This approach does not extend to the granting or creation of other contractual rights. If, for example, on the sale of a hotel

business owned by a high profile celebrity, a contract is entered into to retain the personal services of the celebrity for a specified period after the sale, the value of these contractual rights do not form part of the value of goodwill.

Does work in progress form part of the goodwill of a professional business?

49. Work in progress which has been completed to a stage that it has been converted into a recoverable debt does not constitute goodwill. Any capital proceeds received for work in progress of this kind are paid for the assignment of the debt and the concession in section 118-250 does not apply.

50. Work in progress that is incomplete and for which there exists no legal liability for payment is not a CGT asset in terms of section 108-5. It does not form part of the goodwill of a business and section 118-250 does not apply.

Operation of the goodwill concession in section 118-250

51. For section 118-250 to apply, there must be:

(a) a change in the ownership of a business of a taxpayer; or

(b) a change in the ownership of an interest of a taxpayer in a business; or

(c) an ending of a business or an interest in a business

and the taxpayer must make a capital gain attributable to the goodwill of the business. If section 118-250 applies, half of the capital gain is disregarded.

52. The section also requires the net value of the business (and any related businesses) or the taxpayer's interest in the business (and any related businesses) be less than a business exemption threshold of $2 million (indexed from 1993-94) at the time of disposal. The threshold for the 1998-99 income year is $2,248,000.

53. As to the requirement that there be a 'capital gain attributable to the goodwill of the business', a taxpayer can only make a capital gain if a CGT event happens (section 102-20). So, there is a capital gain attributable to goodwill of the business for the purposes of section 118-250 if a CGT event happens and a capital gain is made in relation to the goodwill of the business.

54. If a change of ownership of a partner's interest in the partners' business occurs or that interest ends, and the partner makes a capital gain on disposal of their interest in the goodwill, there is a capital gain

attributable to goodwill of the business for the purposes of section 118-250.

Measurement of goodwill

55. Parties to an agreement for the sale of a business often allocate a discrete part of the sale proceeds to goodwill. We will accept the amount a vendor and purchaser attribute or allocate to goodwill as capital proceeds for goodwill provided that all of the following requirements are met:

(a) The vendor owns the goodwill of the business, is entitled to dispose of it and has actually disposed of the goodwill in disposing of the business.

(b) The parties are dealing with each other at arm's length in transacting the sale and in allocating the sale proceeds.

(c) The parties do not include in the value of goodwill an amount that should be properly attributed to an 'identifiable asset' (in terms of the accounting standards) distinct from goodwill. The only exception is the granting of a restrictive covenant protecting the goodwill may be treated in accordance with paragraphs 45 and 46 of this Ruling. 'Identifiable asset' in terms of the accounting standards includes:

  (i) conventional work in progress;

  (ii) the get-up of a business (e.g., its business or trade name, logos, slogans, symbols, signs, colour schemes and visual images) to the extent to which it is capable of being individually identified and specifically recognised in financial statements; and

  (iii) scientific, technical, industrial or commercial knowledge or information (e.g., know-how and mining, quarrying or prospecting information) to the extent to which it is capable of being individually identified and specifically recognised in financial statements.

(d) The amount of capital proceeds attributed by the parties to goodwill, when added to the proceeds for all other identifiable assets of the business, equals the total proceeds received for the sale of the business.

56. In determining whether taxpayers are dealing at arm's length in transacting the sale and in allocating the sale proceeds especially to

goodwill, all relevant circumstances are taken into account. If the amount allocated to goodwill is above or below the market value of the goodwill this is a factor to consider in determining whether the parties are not dealing at arm's length.

57. If on a sale of a business parties have not dealt with each other at arm's length in allocating the sale proceeds to the assets sold and, as a result, have attributed an unreasonably large proportion of the proceeds to the disposal of goodwill, section 116-40 enables the Commissioner to attribute reasonably part of the proceeds to the goodwill and part to the other assets.

58. If the parties have not apportioned the sale proceeds between the disposal of goodwill and of other identifiable business assets, section 116-40 enables the Commissioner to attribute reasonably part of the proceeds to the goodwill and part to the other assets.

Valuation of goodwill

59. There are several possible approaches to valuing goodwill. Our preferred approach on the sale of a profitable business or a business expected to be profitable is the difference between:

(a) the total consideration received for the business if the parties are dealing with each other at arm's length; and

(b) the sum of the market values of all identifiable net assets (in terms of the accounting standards) other than goodwill of the business disposed of.

60. This is similar to the approach adopted in the accounting standards. We recognise and accept, however, that other valuation methods may be adopted. Whichever method is adopted we expect the total proceeds received for the sale of the business to equal the total proceeds allocated to the identifiable assets (in terms of the accounting standards) of the business.

When is goodwill acquired?

61. If goodwill is acquired from a business owner on the acquisition of a business under a contract, the purchaser acquires it on the date the contract is entered into (subsection 109-5(2), event A1, case 1).

62. If goodwill is acquired from a business owner other than under a contract, it is acquired when the vendor of the goodwill stops being its owner (subsection 109-5(2), event A1, case 1).

63. If a taxpayer commences business and starts to create goodwill, the goodwill of the business is acquired when the taxpayer starts work

that results in the creation of the goodwill (subsection 109-10, item 1). When a taxpayer starts the work resulting in the creation of goodwill of a business is a question of fact dependent on the circumstances of each particular case.

Cost base of goodwill

64. The cost base of goodwill purchased in an arm's length transaction includes money paid or required to be paid in respect of acquiring the goodwill and the market value of any other property given or required to be given in respect of its acquisition.

65. The cost base of internally generated goodwill does not include any expenditure incurred in the course of carrying on a business and has the essential character of a working expense of the business or a cost of the trading operations of the business.

66. The cost base of goodwill is separate and distinct from, and does not include, the cost base of other assets of a business - even business assets which are sources of goodwill.

67. If a taxpayer commences a business, or internally generates goodwill in an existing business, the cost base of the goodwill does not include any figure for the taxpayer's (that is, sole trader's or partner's) own effort in building up the goodwill. The value of services performed by an individual taxpayer personally are not included in the cost base of an asset.

68. The cost base of goodwill includes capital expenditure to the extent it is incurred to increase the value of the goodwill and is reflected in the state or nature of the goodwill when a CGT event happens (subsection 110-25(5)). It also includes capital expenditure to the extent it is incurred to establish, preserve or defend the taxpayer's title to, or right over, the goodwill (subsection 110-25(6)).

69. Costs incurred in acquiring knowledge or information - e.g., know-how, mining, quarrying or prospecting information, trade secrets and secret formulae - do not form part of the cost base of goodwill. Similarly, costs incurred in developing conventional work in progress do not form part of the cost base of goodwill.

Transferability of so-called 'personal goodwill'

70. If a sole practitioner disposes of their business, the part of the goodwill of the business that emanates from their personality, reputation, skills or attributes is not transferable. Similarly, if key employees of the sole practitioner are not employed by the purchaser on the disposal of the business, any part of the goodwill that emanates

from their personality, reputation, skills or attributes is also not transferable. However, other sources of goodwill continue to draw custom to the business even though the owner or employee has no further connection with the business and, in that respect, the goodwill can be sold.

Does a CGT event happen to goodwill when a business ceases?

71. The most specific CGT event when a business permanently ceases is CGT event C1 (about loss or destruction of a CGT asset) in section 104-20 . The market value substitution rule does not apply: section 116-25.

72. A temporary closure of a business or a move in location of a business does not constitute a permanent cessation of business and neither CGT event C1 nor CGT event C2 (about cancellation, surrender and similar endings of intangible assets) in section 104-25 happens to the goodwill.

Whether a change occurs in the ownership of a business or an interest in it, for the purposes of section 118-250, if part of a business is disposed of

73. If a business owner (whether a sole trader or practitioner, a company, a trustee of a trust estate) disposes of their entire business, goodwill may be transferred with that business. Section 118-250 applies to any capital gain attributable to the goodwill.

74. If the business owner disposes of an interest in their business (e.g., by admitting a partner), goodwill may also be transferred with the disposal of that interest. Section 118-250 applies to any capital gain attributable to the goodwill.

75. If the business owner disposes of part of a business (in the sense of a particular business operation or activity) that is a discrete business in its own right and is sold as a business, goodwill may also be transferred with that business. It must include a sale of sufficient assets including goodwill to enable a purchaser to carry on the business in the same way as the vendor did previously. Section 118-250 also applies to any capital gain attributable to the goodwill.

76. If what the business owner transfers, however, is something less than a discrete business, it involves merely a disposal of identifiable assets of the business but without goodwill. It is a mere sale of assets. Section 118-250 does not apply.

77. It is a question of fact and degree whether a discrete business is sold or whether something less than a discrete business is sold.

78. If one or more identifiable assets of a business are disposed of, and not a discrete business, and the sale proceeds exceed the market value of the separate assets, the extra receipt is not for goodwill (there being no business disposed of) and is to be apportioned over the assets. The extra receipt increases the capital proceeds received by the vendor for the assets and increases the acquisition cost of the assets to the purchaser. It is to be apportioned on a reasonable basis over the assets.

79. If a partner of a partnership - the partners of which carry on business - disposes of their interest in the partnership (in whole or in part), it is a change in the ownership of the partner's interest in the business for the purposes of section 118-250 and the concession applies to any capital gain attributable to the goodwill of the business.

Date of effect

80. This Ruling applies to years commencing both before and after its date of issue. Its application in years before its date of issue is subject to the statutory limits of section 170 of the 1936 Act. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

81. Paragraphs 32 to 38 of this draft Ruling - on the difference between an expansion of an existing business and the acquisition of a new business - are more favourable to taxpayers than paragraphs 2 to 6 of Taxation Ruling IT 2328. In accordance with paragraph 12 of TR 92/20, these paragraphs of the draft Ruling, when finalised, will have both a past and future application (subject to the statutory limits of section 170 of the 1936 Act).

82. Paragraphs 44 to 48 of this draft Ruling - on the relationship between restrictive covenants and goodwill - are more favourable to taxpayers than paragraphs 8 to 12 of Taxation Ruling TR 95/3. In accordance with paragraph 12 of TR 92/20, these paragraphs of the draft Ruling, when finalised, will also have both a past and future application (subject to the statutory limits of section 170 of the 1936 Act).

Explanations

High Court decision on goodwill

83. The High Court of Australia in *FC of T v Murry* 98 ATC 4585; (1998) 39 ATR 129 expressed its view on what constitutes 'goodwill' for the purposes of the former section 160ZZR of the 1936 Act (the equivalent of section 118-250 of the 1997 Act).

84. The High Court's decision in the *Murry* case provides the following guidance on many aspects of the law relating to goodwill (references to paragraph numbers in square brackets are to paragraphs of the joint reasons for judgment of the majority justices) including the meaning of 'goodwill':

(a) Goodwill is an accounting and business term as well as a legal term. The understanding of accountants and business persons as to the meaning of the term differs from that of lawyers: paragraph [13].

(b) Goodwill is really a quality or attribute derived from other assets of the business. Its existence depends on proof the business generates and is likely to generate earnings from the use of the identifiable assets, locations, people, efficiencies, systems, processes and techniques of the business. It includes whatever adds value to a business: paragraph [12]. The attraction of custom is central to the legal concept of goodwill: paragraph [20].

(c) Goodwill has three aspects - property, sources and value - which combine to give definition to the legal concept of goodwill. What unites these aspects is the conduct of a business. Goodwill is something which attaches to a business. It cannot be dealt with separately from the business with which it is associated: paragraph [22]. Goodwill is inseparable from the conduct of the business: paragraphs [4], [23], [30], and [36].

(d) Goodwill is property, and an asset of a business, because it is the right or privilege of the owner of a business to use the other assets of the business, to make use of all that constitutes the attractive force which brings in custom and to conduct the business in substantially the same manner and by substantially the same means which in the past have attracted custom to the business: paragraph [23].

(e) The goodwill of a business is the product of combining and using the tangible, intangible and human assets of a business for such purposes and in such ways that custom is drawn to it: paragraph [24]. It may be site, personality, service, price or habit that obtains custom: paragraph [67]. Goodwill is a quality or attribute that derives, among other things, from using or applying other assets of a business, for example, use of a trade mark or a particular site, or from selling at competitive prices: paragraph [24]. It is more accurate to refer to goodwill as having sources than it is to refer to it as being composed of elements: paragraph [24]. Many of the sources of goodwill are not themselves property. Nor are they assets for accounting purposes. Examples include manufacturing and distribution techniques, the efficient use of the assets of a business, superior management practices and good industrial relations: paragraph [25]. Other examples are location of the business, a lack of competition resulting from an enforceable restrictive covenant, and statutory monopolies in respect of products of a business such as patents or trade marks: paragraph [26]. Expenditures such as advertising and promotional expenses are also sources of goodwill: paragraph [27].

(f) Goodwill is legally distinct from the sources that have created the goodwill: paragraphs [4], [30] and [44].

(g) Goodwill is an indivisible item of property: paragraphs [4], [32], [37] and [53]. It does not inhere in the other assets of a business: paragraphs [36] and [53]. The goodwill of a business is one whole: paragraph [35].

(h) When an asset of the business is sold, and the business is not, the sale may reduce the value of the goodwill of the business. Nevertheless, the sale does not involve a disposal of the goodwill of the business or any part of it: paragraphs [31], [32] and [37]. The sale of an asset which is a source of goodwill, separate from the business itself, does not involve any disposal of the goodwill of the business: paragraph [4].

(i) The cases contain many statements referring to site goodwill, personal goodwill, name goodwill and monopolies giving rise to goodwill. But these descriptions of goodwill were used because, in particular contexts, they were helpful to explain certain attributes or properties of goodwill: paragraph [37].

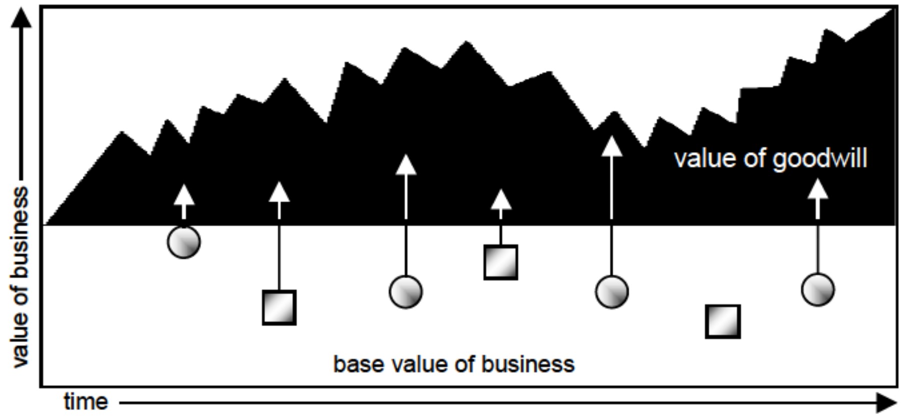
(j) Once goodwill as property is recognised as the legal right or privilege to conduct a business in substantially the same manner and by substantially the same means which in the past have attracted custom to the business, it follows that a person acquires goodwill when he or she acquires that right or privilege: paragraph [45]. In the case of goodwill acquired from another person, the date of transfer will be the date on which the asset was acquired. More difficult questions arise in the case of goodwill created by a taxpayer in the course of conducting a new business. One difficulty in such a case is to identify the date when the goodwill was acquired: paragraph [47].

(k) The sources of the goodwill of a business may change and the part that various sources play in maintaining the goodwill may vary during the life of the business. But, as long as the business remains the 'same business', the goodwill acquired or created by a taxpayer is the same asset as that which is disposed of when the goodwill of the business is sold or otherwise transferred: paragraph [45].

(l) In determining whether the 'same business' is being carried on, the sources of the goodwill may have changed so much that, although the business is of the same kind as previously conducted, it cannot be said to be the same business: paragraph [46].

(m) Goodwill has value because it can be bought and sold as part of a business: paragraph [48]. The value of a profitable business may be measured by adopting the conventional accounting approach of finding the difference between the present value of the predicted earnings of the business and the fair value of its identifiable net assets. In a profitable business, the value of goodwill for legal and accounting purposes will often, perhaps usually, be identical. As to a non-profitable business, there may be a marked difference between the value of goodwill for legal purposes and its value for accounting or commercial purposes. That is because goodwill for legal purposes includes everything that adds value to the business: 'every positive advantage' as Wood V-C pointed out in *Churton v. Douglas* (1859) 70 ER 385. As a result, a business may have valuable goodwill in the eyes of the law although an accountant would conclude that the business either has no goodwill or that, if it has, it is of nominal value only.

Depiction of goodwill of a business and its sources



 = Assets of business (most are sources of goodwill)

 = Other sources of goodwill which are not assets of the business such as quality and reputation of product or services, managerial skill, customer relations and patronage, harmonious industrial relationships with employees, good credit, efficient use of assets of the business, efficient manufacturing and distribution techniques, attractive personalities of business owners and their key employees.

Meaning of 'goodwill'

85. Subsection 108-5(2) defines 'CGT asset' to include 'goodwill'. The term 'goodwill' is not defined, however, either in Part 3-1 or in the 1997 Act generally. This Ruling respectfully adopts the High Court's views in paragraph 84 above including its views on the nature of goodwill.

86. Goodwill differs in its composition in different trades or industries and in different businesses in the same trade or industry. One source may preponderate in one business and another source in another business: *IRC v. Muller & Co's Margarine Ltd* [1901] AC 217 per Lord Macnaghten at 224. What goodwill means must depend, therefore, on the character and nature of the business to which it is attached: *Trego v. Hunt* [1896] AC 7 per Lord Macnaghten at 23.

Are so-called 'site goodwill', 'personal goodwill' and 'name goodwill' separate assets in their own right for the purposes of Part 3-1?

87. No. Statements in decided cases referring to site goodwill, personal goodwill, name goodwill and monopolies giving rise to goodwill are merely descriptions of the goodwill of a business and do not detract from the fact that goodwill is one CGT asset. Goodwill is a composite thing emanating from a number of sources working together. The majority justices in the *Murry* case rejected a view that goodwill is not an asset but a series of assets that inhere in other assets of a business: paragraph [36] (98 ATC at 4593; 39 ATR at 140).

What are the consequences of goodwill of a business being one CGT asset?

88. The goodwill of a business that commenced before 20 September 1985 remains a pre-CGT asset provided the same business continues to be carried on. As the majority justices of the High Court said in the *Murry* case (98 ATC at 4594; 39 ATR at 143), 'as long as the business remains the "same business" (cf *Avondale Motors (Parts) Pty Ltd v. FC of T* (1971) 124 CLR 97), the goodwill acquired or created by a taxpayer is the same asset as that which is disposed of when the goodwill of the business is sold or otherwise transferred'. For a business that commenced before 20 September 1985, any accretion to its goodwill since 20 September 1985 is not a post-CGT asset.

89. If an entity started business before 20 September 1985, with its goodwill being acquired on commencement of the business, Division 149 (about when an asset stops being a pre-CGT asset) of the 1997 Act needs to be considered in respect of that pre-CGT goodwill. Although the entity may have disposed of all of its other pre-CGT assets, if the pre-CGT goodwill no longer has the same underlying ownership it is treated by Division 149 as being post-CGT goodwill.

Can a business change to such an extent that it is no longer the same business and its goodwill becomes a new asset?

90. It is a question of fact and degree whether the same business is being carried on. Factors to consider include the nature or character of the business, its location and size, the extent of changes in the assets and resources of the business, the activities of the business - whether the activities constitute, or are treated by the business owner as constituting separate or distinct activities, enterprises, divisions or undertakings -and the way in which the business is structured, carried on, managed and controlled.

91. A different approach is adopted in this Ruling to test whether the same business is being carried on for the CGT goodwill provisions from that described in TR 95/31 for the tax loss provisions in subsection 165-210(1). The context of the two sets of provisions is quite different. The word 'business' in its context in subsection 165-210(1) means only one 'overall business' and is a reference to all of the activities carried on or undertaken by the company irrespective of whether those activities constitute or are treated by the company as constituting separate or distinct activities, enterprises, divisions or undertakings (paragraphs 21, 22 and 25 of TR 95/31) whereas the word 'business' is used in a different context in the CGT goodwill provisions. Those provisions can extend to a situation in which a business owner carries on a series of separate businesses, each business having its own goodwill. The High Court said in *Avondale Motors (Parts) Pty Ltd v. FC of T* (1971) 124 CLR 97; 71 ATC 4101; (9171) 2 ATR 312 that the loss provisions in the income tax law 'show an intention on the part of the legislature to impose, in the case of companies, a special restriction on the ordinary right of a taxpayer to treat losses incurred in previous years as a deduction from income (124 CLR at 105; 71 ATC at 4107; 2 ATR at 317).

92. For the CGT goodwill provisions, the same business is carried on and no different goodwill asset is created if the business retains its identity in the sense it continues to be identifiable or recognisable as the particular business originally acquired or commenced. To illustrate this same business test with an example, a business of a printer may have changed over time due to the purchase of new equipment and the adoption of improved technologies. The printer may now attract a different type of client such as large corporate clients (due to the capacity to produce high quality public relations material, annual reports, etc). Formerly, the printer may only have provided services to small local businesses (e.g., business cards, calendars, invoice books, stationery). These changes to the printing business, even considered in combination, are not so substantial as to justify a finding that the business is not the same as the one originally acquired or commenced. It is not a different business and the goodwill remains the same CGT asset.

93. The High Court in the *Murry* case considered it '**arguable**' (emphasis added) that the goodwill of the business of an inner Sydney hotel is not the same asset as it was two decades ago because, due to a marketing change and a resulting change in the class of customer patronising the business, it is not the same business as it was then. The High Court said the sources of the goodwill of a business may change and the part that various sources play in maintaining the goodwill may vary over the life of the business to such an extent it can no longer be said that the same business is carried on (98 ATC at

4595; 39 ATR at 143). The question whether a change of business occurs remains one of fact and degree, however, and a change in the nature of the clients of a business does not of itself mean the business is a new business with new goodwill. Many businesses naturally evolve by serving different clients or clients in different markets and offering improved products or services.

94. Unless the facts are such that it can be established that a new business has commenced - rather than an existing business continued - the goodwill of the business is not different from that existing when the business was originally acquired or commenced. This is so in considering whether a pre-CGT business becomes a different post-CGT business or whether a post-CGT business becomes a different post-CGT business.

Goodwill, as a whole, is either a pre-CGT asset or a post-CGT asset

95. The whole of the goodwill of a business is either pre-CGT goodwill (subject to Division 149 - about when an asset stops being a pre-CGT asset - see paragraph 89) or post-CGT goodwill. If, for instance, a taxpayer disposes of a business acquired before 20 September 1985 (a 'pre-CGT business'), the whole of the goodwill of the business is taken to have been acquired before that date and, by paragraph 104-10(5)(a), any capital gain or capital loss is disregarded. This is so even though the goodwill may have grown or diminished since 19 September 1985.

On an expansion of an existing business or on a commencement or acquisition of a new business, is new goodwill acquired?

96. Any accretion to the goodwill of a business does not constitute a capital 'improvement' to the goodwill of the business for the purposes of section 108-70 and is not taken to be a separate CGT asset.

97. If a taxpayer commenced a business before 20 September 1985 ('pre-CGT business') and after that date acquired another business and its goodwill as a going concern ('post-CGT business'), the post-CGT business may either be a separate and distinct business from the pre-CGT business or be subsumed into it so as to form part of the pre-CGT business without changing its essential nature or character.

98. In either event, the goodwill of the post-CGT business does not constitute an 'improvement' to the goodwill of the pre-CGT business.

99. If the two businesses are separate and distinct businesses, the goodwill of the post-CGT business does not affect the goodwill of the pre-CGT business. It is not an 'improvement' to the goodwill of the

pre-CGT business. It is goodwill of a separate and independent business. Section 108-70 therefore does not apply in this situation.

100. If the post-CGT business is subsumed into and forms part of the pre-CGT business, the goodwill of the post-CGT business is also not an 'improvement' to the goodwill of the pre-CGT business. The newly acquired goodwill merges with and becomes part of the composite goodwill of the business. This highlights the composite, fluctuating nature of goodwill. The newly acquired goodwill is not an 'improvement' to the goodwill of the pre-CGT business because it **is** the goodwill - or, at least, it is a **component** of the goodwill - of that business. Again, section 108-70 does not apply.

101. An accretion of internally generated goodwill adds to the composite goodwill of the business. Goodwill of a business may be enlarged by various means but the enlargement is not an 'improvement' to the goodwill of the business. Rather, it **is** the goodwill of the business.

What is the relationship between goodwill of a business and other assets of the business?

102. Goodwill is separate and distinct from other CGT assets of a business. The High Court majority justices in the *Murry* case made it clear (98 ATC at 4587 and 4592; 39 ATR at 132 and 139-140) that goodwill is a quality or attribute derived from other assets of the business and is legally distinct from the sources - including identifiable assets of the business - from which the goodwill emanates. The goodwill of the business does not inhere in the other assets of the business. As their Honours said, 'That which can be assigned and transferred from the business may, while it is connected to the business, be a source of the goodwill of the business but cannot logically constitute any part of the goodwill of the business': 98 ATC at 4592; 39 ATR at 139.

What is the relationship between goodwill of a business and the get-up of the business or knowledge or information used in the business?

103. The get-up of a business - such as its business or trade name, its logos, slogans, symbols, signs, colour schemes and visual images - is a source of goodwill and is not in itself goodwill. Goodwill is legally distinct from the sources which create it: *Murry* (paragraph [4], 98 ATC at 4587; 39 ATR at 132). Goodwill derives from the use of the get-up of a business and from using or applying other assets of the business.

104. Although the Full Federal Court in *FC of T v. Just Jeans Pty Ltd* 87 ATC 4373; (1987) 18 ATR 775 referred to a name of a business, a trade mark, slogans or visual images as **aspects** of goodwill (87 ATC at 4382; 18 ATR at 786) or as **manifestations** or **parts** of goodwill of a business (87 ATC at 4383; 18 ATR at 786), the High Court in the *Murry* case stated that 'it makes no sense to describe goodwill ... as composed of trade marks, land or price, as the case may be' (98 ATC at 4591; 39 ATR at 137-138). The High Court went on to state that 'it is more accurate to refer to goodwill as having **sources** than it is to refer to it as being composed of **elements**' (emphasis added - 98 ATC at 4591; 39 ATR at 138).

105. Scientific, technical, industrial or commercial knowledge or information (such as know-how, mining, quarrying or prospecting information, a trade secret, secret process or formula) are not goodwill. This knowledge or information is not property. Nor is it a CGT asset. It might be a source of goodwill but it is separate from goodwill. This accords with the view in paragraphs 29, 30 and 86 of Taxation Ruling TR 98/3 that mining, quarrying and prospecting information and goodwill are two separate things. The knowledge or information is valuable and its value can be brought to account or realised separately from the business itself and from the goodwill of the business. Goodwill does not attach to the knowledge or information. Rather, goodwill attaches to the business that uses the knowledge or information.

What is the relationship between a restrictive covenant and goodwill?

106. For the purposes of this Ruling, a restrictive covenant means either:

(a) a covenant in an agreement between a vendor and a purchaser for the sale of a business, or in a separate agreement, by which the vendor agrees not to compete in business or to attract clients of the business; or

(b) a covenant between a vendor's employee and a purchaser in an agreement for the sale of a business, or in a separate agreement, by which the employee agrees not to compete in business or to attract clients of the business.

107. A restrictive covenant on the sale of a business is a CGT asset separate from the goodwill of the business. The restrictive covenant constitutes a 'CGT asset' as defined in section 108-5. It is either a proprietary right (paragraph 108-5(1)(a)) or a legal or equitable, non-proprietary right (paragraph 108-5(1)(b)).

108. In the House of Lords decision in *Trego v. Hunt* [1896] AC 7, a restrictive covenant was viewed as being something distinct from goodwill in the sale of a business.

109. The function and goal of a restrictive covenant is to protect the goodwill; it prevents the vendor from destroying the value of the goodwill of the business transferred.

110. The value of goodwill and the granting of a restrictive covenant on the sale of a business are inextricably linked. The absence of a covenant may be reflected in a lower price being paid for goodwill. The presence of a restrictive covenant tends to indicate the parties really do transfer some goodwill, though this is by no means conclusive. As the High Court majority justices said in the *Murry* case, the lack of competition from an enforceable restrictive covenant may enhance the goodwill of a business: 98 ATC at 4591; 39 ATR at 138.

111. If a vendor and a purchaser of a business, dealing at arm's length, do not separately allocate any part of the capital proceeds to a restrictive covenant, we will treat the granting of the covenant as being ancillary to the disposal of the goodwill of the business. The entire consideration qualifies for the concession in section 118-250.

112. We take this approach because:

(a) the intended purpose of a restrictive covenant in a sale of business contract is to facilitate the transfer of the goodwill of the business and to protect the goodwill disposed of by the vendor of the business;

(b) the covenant has no value if the vendor has no intention of competing and, in any event, the vendor is not permitted at law to derogate from their grant: and

(c) we believe, that it reflects business reality.

113. If in their contract of sale, however, a vendor and purchaser dealing at arm's length do allocate separate parts of the capital proceeds to the covenant and to the goodwill, we will accept that the amount they allocate to the goodwill qualifies for the concession in section 118-250.

Does work in progress form part of the goodwill of a professional business?

114. Once work in progress is converted into a recoverable debt, the debt is a CGT asset as defined in section 108-5. The work in progress does not constitute goodwill because it is a separate CGT asset in its own right.

115. Conventional work in progress as referred to in *Stapleton v. FC of T* 89 ATC 4818 at 4826; (1989) 20 ATR 996 at 1005 and by Barwick CJ in *Henderson v. FC of T* 70 ATC 4016 at 4020; (1970) 1 ATR 596 at 601 requires closer consideration.

116. Until conventional work in progress is progressed to a stage where it becomes a recoverable debt, it is not a CGT asset. We respectfully disagree with the contrary conclusion reached by the Administrative Appeals Tribunal in *Case 41/96* 96 ATC 417 at 427; *AAT Case 11,020* (1996) 33 ATR 1046 at 1055. Our view that conventional work in progress is not a CGT asset is conclusively demonstrated if it is simply not capable of being completed, say, because it depended entirely on personal performance by a person who dies before its completion.

117. Conventional work in progress does not constitute goodwill. Heerey J in *Coughlan & Ors v. FC of T* 91 ATC 4505; (1991) 22 ATR 109 considered goodwill to be something different from work in progress: 91 ATC at 4508; 22 ATR at 112. Any capital gain on its disposal does not qualify for the concession in section 118-250.

118. A receipt for conventional work in progress is essentially received as an affair of revenue.

119. A receipt of a retiring partner for conventional work in progress is also revenue in nature: *Stapleton v. FC of T* 89 ATC 4818; (1989) 20 ATR 996; *FC of T v. Grant & Ors* 91 ATC 4608; (1991) 22 ATR 237 and *Crommelin v. FC of T* 98 ATC 4790; (1998) 39 ATR 377.

120. A person holding conventional work in progress might create and vest in another person a right to complete the work and to bill for it. CGT event D1 (section 104-35 - about creating contractual or other rights) would happen and the creator would make a capital gain if the proceeds from creating and vesting the right are more than incidental costs they incur: subsection 104-35(3). The proceeds also would be income in ordinary concepts and would be assessable under section 6-5. The anti-overlap provisions of section 118-20 would apply to reduce the capital gain by the amount assessable under section 6-5. The capital gain triggered by CGT event D1 is not attributable to goodwill and the concession in section 118-250 does not apply.

Measurement of goodwill

121. Businesses are bought and sold every day. The parties to a sale of a business need to determine how much of the sale proceeds is properly attributable, and able to be allocated, to:

(a) goodwill; and

(b) the other identifiable assets (including conventional work in progress, the get-up of the business and scientific, technical, industrial or commercial knowledge or information, e.g., know-how and mining, or prospecting information) of the business in terms of the accounting standards.

122. What part of the sale proceeds may be allocated to goodwill depends in part on the scope of the term 'goodwill' in its context in Part 3-1. Goodwill is something separate from the identifiable assets of the business that contribute to it. Goodwill is also something separate from the sources from which it emanates. Goodwill is an item of property that has an existence separate from other tangible and intangible property of a business. The parties, therefore, need to value the goodwill and value separately the other identifiable assets of the business.

123. We will accept the amount of sale proceeds the parties attribute or allocate to goodwill as capital proceeds for the disposal of goodwill provided that all of the requirements in paragraph 55 are met.

Valuation of goodwill

124. There are several possible approaches to valuing goodwill. Some approaches are illustrated in the following example.

125. A business is sold for $500,000. Three assets are disposed of, namely stock, plant and goodwill. The cost price of the stock is $100,000 as is its market selling value and replacement price. The market value of the plant is $50,000.

126. Two valuers value the goodwill of the business. The first valuer is of the view that the goodwill is worth $330,000 while the second valuer places a value of $380, 000 on the goodwill.

127. **Valuation approach 1** is that the market value of the goodwill is equal to the difference between the market values of all other identifiable net assets disposed of and the total sale proceeds received for the business in an arm's length dealing. As the majority justices of the High Court said in the *Murry* case at paragraphs [48] and [49] (98 ATC at 4595; 39 ATR at 144), if a business is a profitable one the value of its goodwill may be measured by adopting the conventional accounting approach, that is, 'finding the difference between the present value of the predicted earnings of the business and the fair value of its identifiable net assets'. **Valuation 1** approach to valuing goodwill adopts the approach in the accounting standards and the numerical result is shown in the table below.

128. **Valuation approach 2** involves apportioning the total sale proceeds over the market value of all assets, assuming the goodwill market value to be that placed on it by valuer 1.

129. **Valuation approach 3** involves apportioning the total sale proceeds over the market value of all assets, assuming the goodwill market value to be that placed on it by valuer 2.

130. **Valuation approach 4** simply accepts the valuation of valuer 1 and **valuation approach 5** accepts the valuation of valuer 2.

Assets sold	**Valuation approach 1**	**Valuation approach 2**	**Valuation approach 3**	**Valuation approach 4**	**Valuation approach 5**
Stock	100	104 (100/480 x 500)	94 (100/530 x 500)	100	100
Plant	50	52 (50/480 x 500)	47 (50/530 x 500)	50	50
Goodwill	350	344 (330/480 x 500)	359 (380/530 x 500)	330	380
Total	500	500	500	480	530

131. Valuation approaches 4 and 5 are not appropriate methods of allocation. Approach 4 results in $20,000 not being allocated to any asset and approach 5 results in the amount allocated to assets exceeding the actual proceeds received.

132. On a disposal of a business that has been or is expected to be profitable, our preferred approach to valuing goodwill is encapsulated in Valuation approach 1.

133. We would take into account all of the relevant circumstances in determining whether the vendor and buyer of the business are dealing at arm's length in allocating consideration to goodwill: *Granby Pty Ltd v. FC of T* 95 ATC 4240 at 4243-4; (1995) 30 ATR 400 at 403. The Federal Court decision in *Collis v. FC of T* 96 ATC 4831; (1996) 33 ATR 438 indicates the Commissioner can treat parties as not dealing at arm's length if one party is indifferent, and submits the exercise of their will to the other party's wishes, as to what part of the

business sale proceeds are allocated to one or more assets (goodwill, for example) to the detriment of other assets of the business.

Other valuation methodologies

134. We do recognise, however, in some circumstances other valuation methodologies may be adopted although we expect taxpayers as a general rule to adopt the Valuation approach 1 method of valuing goodwill.

135. The majority justices of the High Court in the *Murry* case stated that a 'marked difference between the value of goodwill for legal purposes and its value for accounting or commercial purposes' (98 ATC at 4595; 39 ATR at 144) may arise if a non-profitable business is sold.

136. If a non-profitable business is sold, we expect its goodwill be valued by a method supportable by some other valuation methodology if the Valuation approach 1 method of valuing goodwill is not adopted. In these circumstances we still expect the total sale proceeds received for the business to equal the proceeds allocated to identifiable net assets (in terms of the accounting standards).

137. The majority justices of the High Court in the *Murry* case raised the possibility of goodwill being valued for non-profitable businesses on the basis of 'the difference between the revenues generated by the relevant advantages and the operating expenses (other than a share of the fixed costs) incurred in earning those revenues' (98 ATC at 4595; 39 ATR at 144).

When is goodwill acquired?

138. Goodwill, being the legal right or privilege to use the other assets of the business and all that constitutes the attractive force which brings in custom and to conduct a business in substantially the same manner and by substantially the same means which have attracted custom to the business in the past, is acquired when a person acquires that right or privilege.

139. On a disposal of goodwill, a relevant issue in determining how Part 3-1 applies is whether the goodwill was acquired on or after 20 September 1985. If it was acquired before that date, the goodwill is a pre-CGT asset and (subject to Division 149 - about when an asset stops being a pre-CGT asset - see paragraph 89) Part 3-1 disregards any capital gain or capital loss on its disposal. Two situations require consideration in determining when goodwill is acquired. The first situation involves the acquisition of goodwill of an existing business

and the second situation involves the acquisition of goodwill when a business is commenced or the goodwill is internally generated.

140. The first situation involving purchased goodwill is straightforward. Subsection 109-5(2), event A1, case 1, specifies the time of acquisition of goodwill acquired under a contract is when the contract is entered into. If goodwill is acquired from another person other than under a contract, it is acquired when the vendor stops being the owner (subsection 109-5(2), event A1, case 1), that is, the date on which the goodwill is transferred.

141. The second situation, where a taxpayer commences carrying on business or internally generates goodwill in an existing business, requires consideration of section 109-10, item 1. Section 109-10 states that, if you create a CGT asset, such as goodwill, and you own it when it is created, you acquire the asset 'when … work that resulted in the creation' started.

142. Because goodwill must be attached to a business the question when work, resulting in the creation of goodwill, starts needs to be considered in the context of the conduct of that business. When a taxpayer starts work resulting in created goodwill of a business is a question of fact dependent on the circumstances of each particular case. The word 'work' envisages more than a mere contemplation of activity that will create goodwill of a business. 'Work' envisages a continuum of acts, transactions or events from which goodwill of a business emanates.

Cost base of goodwill

143. The cost base of purchased goodwill includes money paid or required to be paid in respect of acquiring the goodwill (paragraph 110-25(2)(a)) and the market value of any other property given or required to be given in respect of its acquisition (paragraph 110-25(2)(b)).

144. As to internally generated goodwill, what money is paid or what property is given, for the purposes of subsection 110-25(2) in respect of acquiring it? Expenditure that is incurred in the course of carrying on a business and has the essential character of a working expense of the business or a cost of the trading operations of the business - e.g., rent, advertising expenses, wages, promotion or marketing expenses - is not money paid or property given in respect of acquiring internally generated goodwill. Rather, it is expenditure incurred in respect of income producing activities or the running of the business. This is so even though an end result of the expenditure may be a contribution to the creation of goodwill.

145. The cost base of goodwill does not include the cost base of other assets of a business. Even though assets of a business such as plant, licences (whether exclusive or non-exclusive licences), statutory permits, quotas, entitlements, contractual rights and items of intellectual property (for example, a trade mark, patent, copyright or registered design) may be sources of the goodwill of a business, they are separate assets from goodwill and their cost bases do not form part of the cost base of the goodwill of the business.

Transferability of so-called 'personal goodwill'

146. What judicial decisions have referred to as 'personal goodwill' is the source of goodwill comprised of the particular personal skills and abilities, reputation, character and personality possessed by persons working in a business. These personal attributes are so intimately identified with, and inseparably attached to, the particular persons that if those persons withdraw from the business the value of its goodwill diminishes. They are inherently unique to the individual and they are not things that are capable of transfer or assignment.

147. Although the personal skills and attributes of a business owner or employees that have contributed to goodwill are not transferable, the fact remains a purchaser is prepared to pay money for the goodwill built up from those attributes. Other sources of goodwill including the habit or inertia of customers will continue to draw custom to the business: *Murry* case at paragraph [37] (98 ATC at 4593; 39 ATR at 141) and paragraph [52] (98 ATC at 4596; 39 ATR at 145). The goodwill is transferable.

Does a CGT event happen to goodwill when a business ceases?

148. If a business permanently ceases both CGT event C1 (about loss or destruction of a CGT asset) in section 104-20 and CGT event C2 (about cancellation, surrender and similar endings of intangible CGT assets) in section 104-25 can apply. Subsection 102-25(1) requires in these circumstances the CGT event that is the most specific to the situation is the one to use.

149. The most specific CGT event when a business permanently ceases is CGT event C1.

150. Subsection 116-30 does not apply to deem the receipt of market value capital proceeds if a CGT asset is lost or destroyed: see section 116-25, event C1. No amount of capital proceeds, therefore, is attributed to the loss or destruction of goodwill resulting from the permanent cessation of a business.

151. A closure of a business for a finite period of time (e.g., an owner closes their shop due to ill health or to take holidays but with the intention of resuming business activities) does not constitute a cessation of business giving rise to a disposal of goodwill.

152. A closure of a shop and a move to new premises do not of themselves constitute a cessation of business. If a business owner moves the location of the shop and continues carrying on the same activities, serving at least some of its customers from the former trading location, the business has not ceased.

153. If, however, a business is moved so that its customer base completely changes and the former business is not known to any of its new customers, the former business ceases. If the business owner had previously purchased the business and its goodwill, a capital loss may arise on the loss or destruction of the goodwill of the business.

154. If a taxpayer undertakes several business activities, the taxpayer may in fact be carrying on several businesses. If one of the activities is permanently discontinued, and the activity constitutes a discrete business in its own right, a loss or destruction of the goodwill occurs in relation to the cessation of that business.

Whether a change occurs in the ownership of a business or an interest in it, for the purposes of section 118-250, if part of a business is disposed of

155. A business owner cannot dispose of goodwill separately from the business to which it attaches.

156. If a business owner (whether a sole trader or practitioner, a company, a trustee of a trust estate) disposes of:

(a) their entire business;

(b) a part of their business (in the sense of a particular business operation or activity) that is a discrete business in its own right; or

(c) an interest in their business (e.g., by admitting a partner)

goodwill may be transferred with that disposal. Section 118-250 applies to any capital gain attributable to the goodwill.

157. If what the business owner transfers, however, is something less than a discrete business, it only involves a disposal of identifiable assets of the business without goodwill. Section 118-250 does not apply.

158. Section 118-250 applies to a change in an entity's ownership of 'a business' or a change in the ownership of an entity's 'interest' in a

business or to an ending of a business or an interest in a business. It does not apply to a change in the ownership of anything less than a business, e.g., a mere sale of assets. Section 118-250 only applies to a change in the ownership of part of a business if that part is severable and is a discrete business in its own right which a purchaser could conduct without more.

159. By its terms, section 118-250 requires a change in the ownership of 'a business'. As paragraph 7 of this Ruling indicates, a business is not a separate entity or thing. It connotes an activity and is clearly distinct from assets used in the business. In referring to an entity's ownership of a business, we take section 118-250 to refer to ownership of the assets (including goodwill) and other things (such as knowledge and information) used in the business activities or transactions.

Disposal of an entire interest in a partnership business

160. A partner's interest in a partnership is a CGT asset (paragraph 108-5(2)(d)). It is a chose in action. A partner's interest in goodwill of the partners' business is also a CGT asset (paragraph 108-5(2)(b)).

161. For a partnership in which the partners conduct a business, a disposal of a partner's **entire** interest in the partnership is a change of ownership of the partner's interest in the partners' business. The entire interest of the partner in the partnership carries with it all the rights and benefits attaching to that interest including the partner's interest in the assets and other things used in the business. Any capital gain made on disposing of the partner's interest in goodwill is a capital gain attributable to the goodwill of the business and qualifies for the concession in section 118-250.

Disposal of part of an interest in a partnership business

162. A disposal of **part** of a partner's interest in a partnership, being a partnership in which the partners carry on business, effects a change of ownership of the partner's interest in the business. This is so because the partner assigns or transfers a chose in action - being a share of their interest in the partnership - which carries with it all the rights and benefits attaching to that share including a share of the partner's beneficial interest in each and every asset of the partnership. In referring to a partner's ownership of an interest in a business, we take section 118-250 to refer to ownership of an interest in the assets (including goodwill) and other things (such as knowledge and information) used in the business activities or transactions. Any capital gain made on disposing of part of the partner's interest in

goodwill is a capital gain attributable to the goodwill of the business and qualifies for the concession in section 118-250.

163. This accords with Taxation Ruling IT 2540 which states, in relation to 'Everett assignments' (that is, where a partner in a partnership assigns part of their partnership interest in a similar way to that before the High Court in *FC of T v. Everett* (1980) 143 CLR 440) that 'the assignment of part of the partnership interest will be treated as a part disposal of the partner's interests in the partnership assets'.

Examples

*(**Note**: for the purposes of simplicity all of the examples ignore incidental costs and transfer costs.)*

Example 1

Meaning of goodwill

Facts

164. Michelle and Ted have set up a theme restaurant. They have spent $200,000 in acquiring various items for the walls of their restaurant. Some items are unusual works of art, some are rare artefacts and some are personal items of superstars.

165. After three years of hectic trading, Michelle and Ted decide to sell the restaurant business. The items have increased in value due to the recent increase in the popularity of certain superstars. Michelle and Ted sell the restaurant and maintain that the profit derived from the sale of the items should be attributed to goodwill. Michelle and Ted maintain it was these items that made the restaurant interesting and attracted custom.

Issue

166. Do the items constitute goodwill?

ATO view

167. No. The items are CGT assets in their own right. Although these assets may have drawn patrons to the restaurant and may be sources of goodwill, they do not form part of the goodwill of the restaurant business and should be treated as assets separate from its goodwill.

Example 2

Goodwill and work in progress

Facts

168. Abacus, an accountant, decides to sell his practice for a total sum of $220,000. The sale contract describes the amount as being for the sale of the business. Working papers show that the amount was determined by reference to conventional work in progress $30,000, office equipment $10,000 and goodwill $180,000. Abacus maintains the amount that should be attributed to goodwill is $210,000, that is, it should include the work in progress.

Issue

169. Should the consideration for the goodwill include an amount for work in progress?

ATO view

170. No. The amount of $30,000 received for work in progress does not constitute a payment for goodwill. This amount should not be taken into account in working out the capital gain made on the disposal of goodwill. The receipt for work in progress is income in ordinary concepts and is included in assessable income under section 6-5.

Example 3

Measurement of goodwill

Facts

171. Eliza decides to sell her engineering business to Bluff Engineering Ltd, with the parties dealing with each other at arm's length. The assets of the business are a lease, stock, a patent, goodwill and machinery. Eliza receives $1 million for the assets of the business allocated in the contract as follows:

	$
Stock (at cost)	200,000
Goodwill (independently valued)	550,000
Machinery (written down value)	100,000
Patent (at market value)	150,000
	$1,000,000

Issue

172. Is $550,000 paid for goodwill acceptable for the purposes of Part 3-1?

ATO view

173. The amount of $550,000 allocated by the parties in their sale agreement accords with the market value for goodwill. If an amount was allocated to goodwill that was above or below $550,000, the Commissioner under section 116-40 may change the amount to market value, especially if the allocation to goodwill was inflated to the detriment of the proceeds allocated to other assets. It would also be expected, if an amount of less than $550,000 was allocated to goodwill, that the amount allocated to the other assets would increase so that the full amount of sale proceeds is allocated to the different assets disposed of.

Example 4

So-called 'monopoly goodwill' and the measurement of goodwill

174. Assume the same facts as in **Example 3**, except that the taxpayer allocates an amount of $700,000 to goodwill on the basis that the goodwill of the business includes the value of the patent.

Issue

175. Does the value of the patent form part of the value of goodwill?

ATO view

176. No. The patent, which is a separate identifiable asset and could be disposed of with or without Eliza's engineering business, should not be taken into account in measuring goodwill. The Commissioner would attribute under section 116-40 an amount of $550,000 to the disposal of the goodwill and $150,000 to the disposal of the patent.

Example 5

Exclusive licences

Facts

177. Hector runs a specialised taxi business in a provincial town. He is the sole holder of an exclusive licence to transport disabled people in the town. His vehicle is specially modified to perform this task.

Issue

178. Is an exclusive licence goodwill?

ATO view

179. The taxi licence under consideration in the *Murry* case was not an exclusive licence (i.e., several other persons owned taxi licences that could be used in the Sunshine coast region). The majority justices of the High Court stated a non-exclusive licence is not a source of goodwill, but indicated an exclusive licence may be a source of goodwill. The fact a licence may be exclusive, and a source of goodwill, does not make that licence goodwill.

180. Hector's business may well include goodwill and the exclusive licence may be a source of that goodwill. However, sources of goodwill do not constitute goodwill in themselves and goodwill is an asset in its own right separate and distinct from its sources. An exclusive licence does not constitute goodwill.

Example 6

Acquisition of goodwill

Facts

181. Ethan, a travel agency consultant, had long been considering commencing his own travel agency business. Early in 1997 he began to 'sound out' various tour operators and hotel chains about representation. He did nothing else about his business plans until early in September 1997 when he finally decided to resign from his employment and start his business. He gave two weeks notice.

182. On 15 September 1997, Ethan commissioned an accountant to register a business name and prepare a full business plan and projected financial statements. On being satisfied with the figures, Ethan organised a three years' lease of premises and selected office equipment for leasing. He contacted a friend in the marketing industry who designed a business logo, advertising materials and travel brochures. He placed an order for business cards and stationery. After recruiting staff, Ethan opened his premises for business at the end of November 1997.

183. Two years later, Ethan's business has become very successful. He approaches his accountant to see what the business is worth and the amount of capital gains tax he may have to pay on any disposal of the business and its goodwill.

Issue

184. When the goodwill of the business was acquired.

ATO view

185. Section 109-10, item 1, provides goodwill is created when work that resulted in the creation of the goodwill started. The continuum of work comprising acts, transactions or events from which goodwill of the business emanates commenced in this case on 15 September 1997. This was the day Ethan started the work that resulted in the creation of goodwill. Before that date, Ethan had not committed himself to commencing the business and was merely taking tentative steps and making general enquiries about carrying on business.

Example 7

'Personal' goodwill

Facts

186. Sarah is a solicitor who provides cut price conveyancing services. She also undertakes some family law and compensation work. Sarah has a small suburban office at her home. The goodwill of Sarah's practice is worth $60,000 and Sarah decides to sell her practice to a local partnership of solicitors. The sources of the goodwill of Sarah's practice are principally her personal skills, widespread reputation in the region and her personality.

Issue

187. Can Sarah transfer her goodwill even though it is principally the product of her personal attributes and reputation?

ATO view

188. Sarah's personal skills and attributes are not assignable. However, Sarah can transfer the goodwill of her practice. Provided Sarah and the purchaser are dealing at arm's length and the $60,000 allocated in the contract is - in accordance with the requirements of paragraph 55 - properly attributable to goodwill, any capital gain on disposal of the goodwill attracts the section 118-250 concession.

Example 8

Facts

189. Jenny owns all of the shares in Joss Pty Ltd, a company that owns backpack hostels in Sydney, Melbourne and Perth. Each hostel was previously residential accommodation that Jenny's company purchased, renovated and obtained permission to operate as a hostel. Joss Pty Ltd opened the Sydney hostel in 1989 and the other two hostels in 1993.

190. Jenny is a director of Joss Pty Ltd and is the principal manager of the three hostels, although the company does employ local managers to handle the day to day affairs of the company in each city. These managers report directly to Jenny. Jenny regularly visits each hostel to see if it is operating efficiently and she is actively involved in the management of each hostel.

191. Joss Pty Ltd's computer system is located in Sydney where Jenny resides, which allows Jenny to monitor all transactions at each of the three hostels. One set of accounts is prepared for the operations of the three hostels and the company employs a part-time accountant in Sydney to look after the accounts of the business.

192. Jenny decides to sell the Perth hostel. Jenny finds that some of her customers visit her other hostels as they travel but customers usually only stay in one of her hostels during their visit to Australia. Each hostel is called 'J's Doss House'.

Issue

193. Does the disposal of the goodwill qualify for the concession in section 118-250?

ATO view

194. Yes. While the vendor carried on one business of managing three hostels, the purchaser intended to manage one hostel as a discrete business. In all the circumstances, the Perth hostel constitutes a separate business in its own right. Its disposal effects a change in ownership of a business as required by section 118-250 and any capital gain on the goodwill qualifies for the concession in section 118-250.

Example 9

Cessation of business

Facts

195. In 1987, Roger decides to open a clothing shop in Bondi. The shop - which was vacant before Roger's tenancy - is known as 'RG's'. Two years later, Roger purchases a clothing shop in Paddington - which is only a few kilometres from the Bondi shop - and pays $100,000 for the goodwill. Roger runs the Paddington business under the former trading name and management and maintains separate banking accounts and financial records from those of the Bondi shop.

196. The Paddington shop begins to lose money in 1993 and is closed in 1994. In an attempt to retain customers, Roger contacts the Paddington clientele and is able to encourage 25% of them to transfer their custom to the Bondi shop.

Issue

197. Does a CGT event happen to the goodwill when the Paddington shop closes?

ATO view

198. The facts that each business is managed and controlled separately, has separate banking and financial records and is carried on under a different trading name indicate Roger is carrying on two businesses.

199. In these circumstances, CGT event C1 - about loss or destruction of a CGT asset - happens to the goodwill of the Paddington business, which is lost on its closure. Roger makes a capital loss because he paid $100,000 for the goodwill and is not receiving any capital proceeds for its loss. The fact Roger was able to attract 25% of the Paddington customers does not affect this outcome.

Example 10

Disposal of goodwill by partners

Facts

200. Rita and Daryl carry on a lawn mowing business in partnership. The partnership mows lawns in two suburbs of Perth, Leederville and Subiaco.

201. Rita and Daryl decide to reduce their workload and sell for $40,000 their lawn mowing round in Subiaco, including cylinder and rotary lawn mowers and customer records of cutting schedules and other requirements. They enter into a sale contract in which they undertake not to solicit the business of their Subiaco customers. The Subiaco round is severable from the other round and is capable of being conducted by a purchaser as a discrete - though small - business in its own right. An amount of $25,000 is allocated in the sale contract as capital proceeds for goodwill.

202. Rita and Daryl continue to mow lawns in Leederville.

Issue

203. How should the amount of $12,500 Rita receives for her interest in the goodwill be treated for Part 3-1 purposes?

ATO view

204. Daryl and Rita have disposed of their entire interests in a discrete business along with their interests in its goodwill. Rita makes a capital gain of $12,500 on the disposal of her interest in the goodwill of the Subiaco business.

205. Rita qualifies for a reduction in the gain under section 118-250.

206. The $25,000 forms part of the cost base of the purchaser's goodwill.

Example 11

Disposal of goodwill to a new partner entering a partnership

Facts

207. Instead of selling the Subiaco lawn mowing round (see **Example 10**), Rita and Daryl decide to allow a new partner into the partnership on the basis that the new partner does all lawn mowing in January and February each year.

208. The new partner pays $30,000 to the partnership for an interest in the partnership including an agreed amount of $20,000 for the acquisition of an interest in goodwill.

Issue

209. How should Daryl and Rita treat the $20,000 received for the goodwill?

ATO view

210. There has been a change in the ownership of the interests of Rita and Daryl in the business. They each disposed of a share of their interest in the partnership that carried with it an interest in the assets of the partnership. Section 118-250 applies. CGT event A1 happens to the interest Rita and Daryl disposed of in the partnership.

Detailed contents list

211. Below is a detailed contents list for this draft Ruling:

Your comments

212. If you wish to comment on this Ruling please send your comments by: 15 February 1999

to:

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