VALUATION OF GOODWILL FOR TAX PURPOSES

James P. Catty

President, Corporate Valuation Services Limited

Chair, International Association of Consultants, Valuators and Analysts

FEDERATED PRESS
BUSINESS AND LEGAL PUBLISHING

Valuation of Goodwill for Tax

- All businesses have these intangible assets that may be treated as "goodwill" for Canadian tax purposes:
  - Company Name
  - Major Brands
  - Customer Relationships
  - Assembled Workforce
  - Systems & Software
  - Technology

Valuation of Goodwill for Tax

- Company Name vs Brand
  - Note the size of Nestle and the size of KitKat.

Valuation of Goodwill for Tax

- First let us look at the law.

Valuation of Goodwill for Tax

- For Canadian tax purposes intangible assets are considered "Eligible Capital Property".
- Broadly this category may be described as any intangible capital property.
- All costs that:
  - Do not qualify for capital cost allowance.
  - Are not fully deductible in the year of acquisition.

Valuation of Goodwill for Tax

- On a purchase all allocated original costs are put into an expenditure pool "Cumulative Eligible Capital" (CEC).
- CEC is:
  - Increased by 75% of each "eligible capital expenditure".
  - Decreased by 75% of any dispositions.

Valuation of Goodwill for Tax

- "Eligible capital expenditure" is defined in subsection 14(5) of the *Income Tax Act* is an outlay or expense made or incurred by a taxpayer:
  - in respect of a business
  - as a result of a transaction occurring after 1971
  - on account of capital
  - for the purpose of gaining or producing income from the business (whether or not income from the business was actually produced by such outlay or expense).
- When there is more than one business in a company all the eligible capital expenditures form part of the cumulative eligible capital.

Valuation of Goodwill for Tax

Example

- Clever Inc. uses a process it has developed.
- It receives consideration for disclosing the process and allowing it to be used by a third party.
- Knowledge of the process is intangible property therefore not depreciable.

Valuation of Goodwill for Tax

- Proceeds from any outright sale is considered to be disposition of Eligible Capital Property.
- If the knowledge is not sold but licensed for a period or the use is permitted under a non-exclusive license.
- The proceeds are taxable income.

Valuation of Goodwill for Tax

- Any particular expenditure may be an eligible capital or a current expense depending on the circumstances.
- Similarly consideration may be either proceeds from disposition or income.
- Either characterisation is a question of fact.
- A mirror image test is commonly used by the CRA for assessing sales.

Valuation of Goodwill for Tax

- In a disposal the taxpayer looks in the mirror to see if the property was being purchased how would the cost be classified?
- The mirror image test is significant in determining if the disposition of customer lists, trademarks, government rights, etc. relate to eligible capital property or income.

Valuation of Goodwill for Tax

- Any consideration received for eligible capital property dependent on the use of or production from it does not result in an eligible capital amount but is income.

Valuation of Goodwill for Tax

- The courts have referred to several definitions of goodwill, the two most common are:
  - “Goodwill is the whole advantage, whatever it may be, of the reputation and connection of the firm which may have been built up by years of honest work or gained by lavish expenditures of money".

Valuation of Goodwill for Tax

- Goodwill is "the privilege, granted by the seller of a business to the purchaser, of trading as his recognized successor; the possession of a ready-formed 'connection' of customers, considered as an element in the saleable value of a business, additional to the value of the plant, stock-in-trade, book debts, etc.".

Valuation of Goodwill for Tax

- Goodwill cannot be separated from the business itself.
- It follows the business and may be sold with the business, but it cannot be sold separately. Generally, goodwill arises as a recognizable asset only when a business is acquired at a price in excess of the value, as a going concern, of its net assets.

Valuation of Goodwill for Tax

- Where goodwill as a recognizable asset is acquired by the purchaser the consideration given for the goodwill, as well as any legal and accounting fees that can be directly associated with the purchase is an eligible capital expenditure.

Valuation of Goodwill for Tax

- Under Section 68 of the Income Tax Act (ITA) if the portion of the total consideration allocated to goodwill appears unreasonable or if the amount of the goodwill is not specified in the agreement of purchase and sale the CRA can, on its own, deem a reasonable amount for goodwill.
- This amount is then applied uniformly to both parties.

Valuation of Goodwill for Tax

- Payments for acquiring lists or ledgers of clients, customers or subscribers must be reviewed to determine whether they are capital or operating expenses.
- Generally the cost of a list bringing an enduring benefit is an eligible capital expenditure.
- Costs of obtaining a trademark registration are deductible including designing, legal, registration and payments made to refrain from contesting the registration.

Valuation of Goodwill for Tax

- A payment for a trademark of enduring value is an "eligible capital expenditure".
- An outlay or expense incurred to attempt to or acquire a patent, franchise, concession or licence is an eligible capital expenditure if it did not result in the acquisition of a depreciable property.

Valuation of Goodwill for Tax

Example

- Milk quotas issued by provincial milk marketing boards are generally granted at no cost to the producer.
- Transfers of quotas for value may generally be made subject to the terms and approval of the board.
- Cost of a milk quota purchased after 1971 is an eligible capital expenditure.
- A quota exchange fee paid to a milk marketing boards to increase an existing quota is also an eligible capital expenditure.

Valuation of Goodwill for Tax

- The costa of rights or licences issued under a governmental authority are eligible capital expenditures.
- An amount paid by a taxpayer to another person at arm's length to obtain their covenant not to engage in any similar business within a designated geographical area during a specified period of time may be an eligible capital expenditure.

Valuation of Goodwill for Tax

- The calculation of cumulative eligible capital (CEC) property and its amortization is complex.
- The amortization charge for the CEC is called cumulative eligible capital amount (CECA).
  - Each tax year end CEC balance is calculated as follows:

	CEC at the beginning of the year
+	Additions at 75% of cost
-	Disposals at 75% of proceeds
=	Base CEC
-	CECA claimed
=	CEC end of year

Valuation of Goodwill for Tax

- If base CEC is positive and the business ceases to continue the remaining balance is deducted as a terminal loss.
- If base CEC is positive and the business continues to operate the taxpayer can claim CECA of up to 7% of the remaining balance (deduction is permissive).
- There is no half-year rule, and CECA can be claimed regardless of whether there are any assets in the pool.

Valuation of Goodwill for Tax

- If CEC is negative recapture is triggered and there is an income inclusion computed as:

  recapture = 50% [proceeds of dispositions original costs] + Σ CECA

- Original cost is the total cost of all the property that was added to the CEC pool before making the 75% adjustments.
- Σ CECA is the amount of CECA that has been claimed over the life of the asset.
- This equation is similar to that used for depreciable capital property.

Valuation of Goodwill for Tax

- Whereas 50% [proceeds ACB] would be reported as a capital gain for depreciable capital property it is included in business income for eligible capital property.
- Recapture for depreciable capital property is ACB less UCC which equals the amount of CCA taken over the life of the asset.
- For eligible capital property, recapture is the original cost less CEC which equals Σ CECA.

Valuation of Goodwill for Tax

- If the taxpayer wishes to recognize a capital gain on the sale of eligible capital property rather than an income inclusion, it can file an election.
- To qualify the proceeds of disposition must exceed cost; the property can be any eligible capital property except for goodwill.
- Additions are reduced by 50% of the gain recognized by a non-arm's length transferor.

Valuation of Goodwill for Tax

- This is similar to how, for depreciable capital property, the Un-depreciated Capital Cost (UCC) of an asset acquired from a related party is the transferor's Adjusted Cost Base (ACB) plus 50% of the capital gain on the disposition.

Valuation of Goodwill for Tax

- Another equation may be used to determine recapture.

  recapture = 66% [negative CEC balance – Σ CECA]

  + lesser of: (i) negative balance and (ii) Σ CECA

- However both equations have the same result.

  66% [negative balance – Σ CECA]

  = 66% [(additions – 75% disposals – Σ CECA) – Σ CECA]

  = 66% [75% disposals – 75% additions]

  = 50% disposals – 50% additions

  = 50% [proceeds – cost]

Valuation of Goodwill for Tax

Lesser of: (i) negative balance and (ii) Σ CECA

= lesser of (i) (75% additions – 75% disposals – Σ CECA) and (ii) Σ CECA

= lesser of (i) 75% disposals – 75% additions + Σ CECA and (ii) Σ CECA

… disposals exceed additions, therefore

= Σ CECA

Valuation of Goodwill for Tax

Therefore:

75% [negative CEC balance – Σ CECA]

+ lesser of: (i) negative balance and (ii) Σ CECA

= 50% [proceeds of disposition original cost]
+ Σ CECA

Valuation of Goodwill for Tax

Example

- Clever Inc. had a Cumulative Eligible Capital of $3,260,000 at the end of 2010.
- During the year it sold a license for a $1,320,000 flat fee and bought property and other tangibles for $340,000.

Valuation of Goodwill for Tax

- Its Base CEC was as follows:

	$
Balance 1 January 2011	3,260,000
Additions (cost $640,000)	480,000
Disposals (proceeds $1,320,000)	(990,000)
	2,750,000
CECA claimed (7%)	(192,500)
Balance 31 December 2011	2,557,500

Valuation of Goodwill for Tax

- For Purchase Price Allocation under International Financial Reporting Standards (IFRS) or Canadian Accounting Standards for Private Enterprise (ASPC).
- All intangible assets are stated at fair values.

- A recent share transaction showed the following:

	$'000
Company Name	200
Major Brand	1,300
Customer Relationships	430
Assembled Workforce	120
Systems & Software	150
Production Techniques	100
Goodwill	200
	2,500

Valuation of Goodwill for Tax

HOW MUCH WAS ADDED TO THE CUMULATIVE CAPITAL EXPENDITURE

Valuation of Goodwill for Tax

NOTHING

- The rules only apply to asset transactions.

Valuation of Goodwill for Tax

- If an asset purchase:
  - The $150,000 systems & software would be classed as Capital Cost Allowance.
  - The remaining $2,350,000 of expenditures would give rise to $1,762,500 of Cumulative Capital Expenditures.
  - The first year classification for CECA would be only $123,375.

Valuation of Goodwill for Tax

ANY QUESTIONS ?