OPERATING BUSINESS VALUE : RE-THINKING GOODWILL IN THE 21st CENTURY

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ABSTRACT

This thesis advances a rights-based theory of goodwill which contends that for legal purposes, goodwill is a bundle of rights and privileges enjoyed by the owner of an operating business, central to which is the proprietary right to make use of all that constitutes the attractive force of the business to generate earnings or otherwise create value. This ‘attractive force’ includes everything which adds value to the business and not merely the attributes of the business which can be shown to attract custom. Rather it is all of the assets, advantages and positive attributes of the business working together which bring about the attractive force and result in earnings being generated and value being created. On this ‘added value’ approach, goodwill is legally present in every business which is operating and generating revenue with the expectation that this will continue, regardless of the source of its custom, and irrespective of whether the business is profitable or has excess value in an accounting sense.

The thesis contends that a rights-based legal theory of goodwill is consistent with the reasoning of the majority in *Federal Commissioner of Taxation v Murry* (1998) 193 CLR 605 and importantly, reconciles a number of perceived inconsistencies in the decision concerning the role played by custom. It argues that reconciling these anomalies is critical because their existence has seen two conflicting judicial approaches to goodwill emerge, both of which purport to find their authority in *Murry*. This has been most observable in the taxation area when courts are regularly called upon to resolve matters involving questions of substantial liability to stamp duty and where the existence and value of goodwill is often a determining factor.

The thesis traces the history of goodwill as a legal concept and identifies the significant findings of the majority in *Murry* concerning the nature, existence, sources and value of goodwill for legal purposes. It examines the cases which have struggled to apply the decision in the face of residual uncertainty about the inseverable nature of goodwill, the role played by custom, and where the critical distinction between the existence and value of goodwill is not well understood. The thesis addresses this uncertainty, clarifies the role played by custom, and explains the relationship between the rights-based legal concept of goodwill and the value-based accounting concept.

Finally, the thesis submits that the existence of the bundle of rights and privileges is the reason why an operating business which is generating revenue and is expected to continue to do so, will usually possess excess value in an accounting sense. To demonstrate the point, the author uses the actual sale of an interest in the Gove bauxite and alumina joint venture business to identify with some particularity the benefits its purchaser obtained by reference to the costs, delays and risks it avoided by acquiring the operating business rather than the business’s identifiable assets only. When those costs, delays and risks are quantified, it is not difficult to understand why sophisticated purchasers are often prepared to pay amounts for a business far in excess of the value of its underlying assets in order to acquire the rights and privileges which the law recognises as goodwill.

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ACKNOWLEDGEMENTS

In 2001 the Australian subsidiary of an international resource company sold its share in a thriving Western Australian mining and refining business to a competitor for in excess of US $2 billion. To the surprise of both parties, the Commissioner of State Revenue decided that the highly profitable and capital intensive mining and refining business had no intangible assets, and in particular, no goodwill of any kind. According to the Commissioner, almost the entire value of the business was attributable to its interests in land, most notably its mining tenements. The result was a ‘land-rich’ stamp duty assessment and penalty akin to the gross domestic product of a small country. Not surprisingly, the company liable to pay the stamp duty objected to both the assessment and the penalty, claiming that the business had numerous intangible assets, including goodwill of significant value. The Commissioner disallowed the objection and confirmed the assessment. Both parties called in the lawyers; the lawyers called in the experts; and so began a decade-long journey which ultimately led one of those lawyers to write this thesis.

I would like to thank my supervisors, Professor Antonio Buti and Assistant Professor Penny Carruthers for their encouragement and support throughout my candidature.

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Finally, I would like to thank the company who though the unfortunate recipient of the stamp duty assessment referred to, was eventually the happy recipient of a large refund cheque. While confidentiality prevents me from identifying the company or discussing its case in this thesis, the facts are close enough to those of the case study to give the reader a fairly accurate idea of the issues the company encountered and the challenges it had to overcome to obtain the result that it did.

OPERATING BUSINESS VALUE: GOODWILL IN THE 21st CENTURY

I. INTRODUCTION

A. Thesis statement

More than a hundred years ago an English judge observed that although goodwill was 'very easy to describe', it was 'very difficult to define'.[1] A century later it seemed little had changed when an Australian judge described goodwill as 'an elusive concept and as difficult to hunt as Lewis Carroll's mythical Snarks'.[2] Commentators it seemed fared no better with one equating his quest to exhaustively define goodwill as 'struggling towards some unforeseen Truth when ultimately there was no one Truth and never will be'.[3]

Having now spent a considerable amount of time examining the concept, the writer of this thesis concurs. However, while the holy grail of an exhaustive definition of goodwill may be neither achievable nor capable of expression, what is achievable and capable of expression is a set of principles by which goodwill can be identified, characterised, valued or protected for legal purposes.

These principles were articulated by the majority of the High Court of Australia in *Federal Commissioner of Taxation v Murry* ('*Murry*').[4] This thesis will examine the majority's reasons, and on the basis of those reasons, contend that for legal purposes, goodwill is the bundle of rights and privileges enjoyed by the owner of a going business; central to which is the proprietary right to make use of all that constitutes the attractive force of the business to generate earnings or otherwise create value. This 'attractive force' includes everything which adds value to the business and not just those attributes which of themselves attract custom. Rather it is all of the assets, advantages and positive attributes of the business working together which bring about the attractive force and which result in earnings being generated and value being created.

On this 'added value' approach, goodwill is legally present in every business which is operating and generating revenue and is expected to continue to do so. This is true even if the business is

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1 *Inland Revenue Commissioners v Muller & Co's Margarine Limited* [1901] AC 217, 223.
2 *Uniqema Pty Ltd v Commissioner of State Revenue* (2002) 50 ATR 91, 93 (Pagone J).
3 H P Hughes, *Goodwill in Accounting,* Business Publishing Division, College of Business Administration, Georgia State University, 1982.
4 (1998) 193 CLR 605.

unprofitable or worth no more than its break-up value as unlike accounting concepts of goodwill, goodwill which is recognised by law can exist even if it has no commercial value.[5]

Although goodwill is parasitic in nature in that it is inseparable from and inheres in the business, it is a discrete and indivisible item of property. It does not attach to the business's identifiable assets, even when one or more of those assets are a source of that goodwill. It therefore follows that goodwill is a valuable asset in its own right, and does not simply contribute to or enhance the value of the business's identifiable assets. Nevertheless, if an identifiable asset of a business is capable of generating income independently from the business or its other assets, generally accepted valuation principles ('GAVP') require that this income generating capacity be taken into account when the asset is valued. This may impact upon the value of the business's goodwill if the asset is sold and the overall income generating capacity of the business is subsequently reduced, but otherwise it has nothing to do with goodwill.

It is the author's thesis that an added value approach to goodwill is the correct and preferable approach and reflects the rights-based theory of goodwill advanced by the majority in *Murry*. Importantly, it explains the relationship between the legal and accounting concepts of goodwill and reconciles a number of apparent inconsistencies in the majority judgment concerning the role played by custom. It recognises that goodwill is the product of combining and using all of the assets, advantages and positive attributes of a going business for such purposes and in such ways that custom is drawn, earnings are generated and value is added. In contrast, an approach which confines goodwill to favourable customer relations leaves the themes in *Murry* unreconciled and attempts to re-establish patronage as the touchstone of a doctrine of goodwill which is both legally and commercially irrelevant in 21st century Australia.

For all of these reasons, the author suggests that goodwill be renamed 'operating business value' because it is the fact that the business is operating and generating revenue, with the expectation that this will continue, which gives goodwill both its legal existence and its commercial value.[6]

B. Misunderstandings, misconceptions and *Murry*

The legal doctrine of goodwill is much misunderstood. As an accounting or business concept, goodwill is generally understood to represent the excess value present in a business over and

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5 Goodwill in an accounting sense is usually measured as the excess value present in a business over and above the net value of its identifiable assets less liabilities. See for example International Accounting Standards Board's *IFRS 3 Business Combinations* [34] and Australian Accounting Standards Board's AASB 3 *Business Combinations* [32]. See also HM Revenue and Customs 'Corporate Intangibles Research and Development Manual' (CIRD 30535) Intangible assets: notes on accounting practice: definition and when to capitalise: goodwill: where goodwill is similarly described as 'the difference between the consideration payable for a business and the aggregate fair value of its identifiable assets less liabilities.'

6 *Murry* (1998) 193 CLR 605, 611 [12].

above the value of its identifiable assets.[7] If there is excess value, there is goodwill. If there is no excess value, there is no goodwill. What could be simpler?

However, as a legal concept, goodwill is more complex, because like other forms of property, it is comprised of a bundle of rights and privileges[8] making it difficult to define exhaustively. These rights and privileges, though valuable in a legal sense, may not always translate into excess value in a commercial or accounting sense. For this reason, the law has long struggled to reconcile the comparatively simple value-based accounting concept of goodwill with the more complex rights-based legal concept. The result was a plethora of judicial expressions or definitions of goodwill, none of which were exhaustive, and many of which reflected only the particular aspect or dimension of goodwill which was the subject matter of the inquiry. Subsequent courts would then adopt one or other of these expressions, not always appropriately, and in some instances, treat it as definitive.

Such was the state of the authorities when the High Court of Australia delivered its reasons in *Murry* on 16 June 1998. No doubt, the High Court judges hoped that their extensive discourse on the legal doctrine of goodwill would bring much needed clarity to what had become a murky corner of the law.[9] In particular, their observation that goodwill has three different aspects - property, sources and value - was intended to give context and definition to the legal concept, and at the same time, distinguish it from the less complex value-based accounting concept. Unfortunately, and despite the justices' efforts, Australian courts have interpreted and applied the majority decision in ways which have led to even greater uncertainty. There are at least four reasons why this is so.

The first is a continuing failure on the part of some judges to understand the indivisible nature of goodwill and a consequential reluctance on their part to depart from the historical practice of subdividing goodwill into component parts and allocating its value to particular assets of the business said to be its source.[10]

The second is a continuing failure to understand the relationship between the accounting concept of goodwill and goodwill which is recognised at law; a misunderstanding which in some cases was fostered by the expert witnesses called to assist the court.[11] This is not altogether surprising given

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7 See above n 5.

8 In *Yanner v Eaton* (1999) 201 CLR 351 at 365, the High Court of Australia described property in terms of a bundle of rights saying '"[P]roperty" does not refer to a thing; it is a description of a legal relationship with a thing. It refers to a degree of power that is recognised in law as power permissibly exercised over the thing. The concept of "property" may be elusive. Usually it is treated as a "bundle of rights"'. In describing property as 'a bundle of rights', their Honours were referring to the theory of property advanced by Professor Wesley Newcomb Hohfeld in the early twentieth century. The theory is the subject of a number of articles by Professor Hohfeld including, 'Some Fundamental Legal Conceptions as Applied in Judicial Reasoning' (1913) 23 *Yale Law Journal* 16 and 'Fundamental Legal Conceptions as Applied in Judicial Reasoning' (1917) 26 *Yale Law Journal* 710.

9 Kirby J dissented in the outcome because he found that in the context of Part IIIA of the *Income Tax Assessment Act* 1936 (Cth), the Murrys were conducting a business, and that the taxi licence protected the goodwill of that business such that its sale involved the sale of a business including goodwill. *Murry* (1998) 193 CLR 605, 639 [93].

10 See, for example, *Kizleap Pty Ltd v Chief Commissioner of Stamp Duties* [2001] NSWSC 80 and *Morvic Pty Ltd v Commissioner of State Revenue* [2002] ATC 4459.

11 See, for example, *Alcan (NT) Alumina Pty Ltd v Commissioner of Taxes* (2007) 208 FLR 159 *and Re Origin Energy Power Ltd v The Commission of State Revenue* (2007) 70 ATR 64.

that the experts were invariably accountants or valuers whose understanding of goodwill was rooted in the value-based accounting concept with which they were familiar, rather than the rights-based legal concept articulated by the *Murry* court. As a result, some courts failed to make a distinction between the existence of goodwill for accounting purposes and its existence for legal purposes.

The third reason for the uncertainty concerns the methods by which goodwill may be valued.[12] Assuming that there is no question that 'legal' goodwill exists and that the business is profitable, there is general agreement that it may be valued as a residual using the traditional accounting technique of measuring the difference between the present value of the predicted earnings of the business (or its sale price if applicable) and the fair value of its identifiable net assets. This was the method approved of by the High Court in *Murry*.[13] However, this is not always possible. For example, one or more of the business's identifiable assets may not transact in the market other than in connection with a business such that there are no comparable sales on which to rely in order to ascertain the value of the asset or assets. One may attempt to value it or them using an income approach such as the traditional discounted cash flow ('DCF') methodology, but as will be discussed later in this thesis, such a method invariably leads to some or all of the cash flow of the business being allocated to the subject asset or assets; when in fact the income is usually earned through the combined used of all of the assets of the business. In these circumstances, one method of valuing the goodwill of the business is to use a combined cost and income approach to identify and value the benefits obtained by reference to the costs, delays and risks avoided by a purchaser of the operating business which would not be avoided by a purchaser of the business's identifiable assets alone who would then need to create a business. This 'restoration' method of estimating the value of the goodwill of a business will be explained in some detail later in this thesis.[14]

Valuing the goodwill of an unprofitable business may also be contentious. One reason for this is that in accounting terms, goodwill cannot exist in a business which is unprofitable and worth no more than the total value of its identifiable assets. However, as the *Murry* majority pointed out, goodwill is not dependent on profitability or excess value in order to exist in a legal sense.[15] This is because in legal terms it exists as a bundle of rights and privileges which the law will recognise and protect in the event that they are threatened. Even so, the judges conceded that the goodwill of an unprofitable business may be hard to measure and in some cases may be of only nominal value.

There is one final reason for the uncertainty which has followed the *Murry* decision, and although all four reasons will be examined in some detail in this thesis, this final reason will be given particular

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[12] Ibid.

[13] *Murry* (1998) 193 CLR 605, 624 [49].

[14] The restoration methodology is also explained in detail in the author's joint article with Peter Collinson SC, 'Extracting land value from business enterprise value for land rich purposes', *The Tax Specialist*, vol 13, August 2009, 24-35.

[15] *Murry* (1998) 193 CLR 605, 624-25 [50].

attention. It is the presence of two apparently inconsistent themes which run through the majority's reasons concerning the role of custom, together with some tension in the majority's own application of its reasoning to the relevant facts. On one hand, the judges repeatedly emphasise the centrality of custom to the legal concept of goodwill and on at least one occasion describe goodwill for legal purposes as the 'attractive force that brings in custom and adds to the value of the business'.[16] Then on the other hand, their Honours state that 'patronage has been rejected as the touchstone of goodwill'[17] in favour of a concept which emphasises 'every positive advantage' and 'everything which adds value to the business'.[18] The judges then list some of these 'advantages' and 'things' and include some which, on their face at least, do not seem to be connected with the attraction of custom at all.

As a result, further conflicts have emerged in the case law as to the role custom or patronage plays in any determination of the existence of goodwill for legal purposes. To some judges, *Murry* prescribes a narrow definition of goodwill for legal purposes such that only particular kinds of businesses, selling certain kinds of products, to certain types of customers can be said to possess it.[19] To others, the decision stands as authority for the proposition that all operating businesses possess goodwill in a legal sense, and its existence does not depend upon the business's sources of customer attraction or what product or service the business sells or to whom or how many customers it sells it.[20] Rather, it depends upon whether the business is operating and generating revenue and there is reason to believe that this will continue.[21]

Regrettably, the conflict over *Murry* has led to a plethora of inconsistent decisions and *Murry* has become one of those decisions on which opposing parties and judges rely in support of completely polarised positions. This has occurred most notably in the taxation area where the decisions have involved questions of substantial liability to stamp duty and where the existence and value of goodwill has been a determining factor.

II. HISTORICAL JUDICIAL CONCEPTS OF GOODWILL

A. Goodwill in centuries past

Before examining *Murry* and the decisions which have endeavoured to apply it, it is important to understand the origins of the doctrine of goodwill in common law jurisprudence and the ways in which the doctrine has changed as commerce itself became more complex and sophisticated.

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16 Ibid 630 [68].
17 Ibid 614 [20].
18 Ibid 624-25 [50].
19 For example, Mildren J in *Alcan (NT) Alumina Pty Ltd v Commissioner of Taxes* (2007) (2007) 208 FLR 159, President Barker in *Re Origin Energy Power Ltd v The Commission of State Revenue* (2007) 70 ATR 64 and Martin CJ in *Commissioner of Territory Revenue v Alcan (NT) Alumina Pty Ltd* (2008) 24 NTLR 33.
20 For example, Angel J and Southwood J in *Commissioner of Territory Revenue v Alcan (NT) Alumina Pty Ltd* (2008) 24 NTLR 33.
21 *Murry* (1998) 193 CLR 605, 611 [12].

The modern concept of goodwill has its roots in English jurisprudence of the 19th century. In the early cases, the courts emphasised the patronage of the business and viewed goodwill as little more than customer loyalty. It is probably best summed up by Lord Chancellor Eldon's statement in *Cruttwell v Lye*[22] that goodwill was ‘nothing more than the probability that the old customers will resort to the old place.’[23] However, by the mid nineteenth century, and perhaps in response to the rapid advances in industrial and commercial practices in the first half of that century, a wider view emerged. For example, in *Churton v Douglas,*[24] Wood V-C described goodwill as

> … every advantage - every positive advantage ... that has been acquired by the old firm in carrying on its business, whether connected with the premises in which the business was previously carried on, or with the name of the late firm, or with any other matter carrying with it the benefit of the business.[25]

In *Trego v Hunt*,[26] Lord Herschell approved this definition, describing goodwill as ‘the connection thus formed, together with the circumstances, whether of habit or otherwise, which tend to make it permanent’.[27] In the same case, Lord Macnaghten emphasised the variable nature of goodwill and its importance to a business, describing it as the ‘very sap and life of the business’:

> What "goodwill" means must depend on the character and nature of the business to which it is attached. Generally speaking, it means much more than what Lord Eldon took it to mean in the particular case actually before him in Cruttwell v. Lye where he says: "the goodwill which has been the subject of sale is nothing more than the probability that the old customers will resort to the old place." Often it happens that the goodwill is the very sap and life of the business, without which the business would yield little or no fruit. It 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 expenditure of money.' [28]

The second half of the 19th century was also the period when cases such as *Potter v Commissioner Inland Revenue*[29] and *Commissioner of Inland Revenue v Angus & Co*[30] established that goodwill is property in its own right.

Meanwhile, in *United States in Metropolitan Bank v St Louis Dispatch Co,*[31] Fuller CJ of the United States Supreme Court was emphasising goodwill’s inseverability from the conduct of a business, while at the same time approving its definition in terms of the value created by customer loyalty:

> Undoubtedly, goodwill is in many cases a valuable thing, although there is difficulty in deciding accurately what is included under the term. It is tangible only as an incident, as connected with a

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22 (1810) 17 Ves Jun 335; 34 ER 129.
23 Ibid 346; 134.
24 (1859) Johns 174; 70 ER 385.
25 Ibid 188; 391.
26 [1896] AC 7.
27 Ibid, 17.
28 Ibid 23.
29 (1854) 10 Ex 147; 156 ER 392.
30 (1889) 23 QBD 579.
31 149 US 436 (1893).

going concern or business having locality or name, and is not susceptible of being disposed of independently. Mr Justice Story[32] defined good will to be 'the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices.[33]

B. Goodwill in the 20th century

With the turn of the 20th century came the decision in *Inland Revenue Commissioners v Muller & Co's Margarine Limited* ('*Muller'*)[34] which was to contain two of the most often quoted judicial definitions of goodwill. The first is that of Lord Lindley who said:

> Goodwill regarded as property has no meaning except in connection with some trade, business, or calling. In that connection I understand the word to include whatever adds value to a business by reason of situation, name and reputation, connection, introduction to old customers, and agreed absence from competition, or any of these things, and there may be others which do not occur to me. In this wide sense, goodwill is inseparable from the business to which it adds value, and, in my opinion, exists where the business is carried on. Such business may be carried on in one place or country or in several, and if in several there may be several businesses, each having a goodwill of its own.[35]

The second is that of Lord Macnaghten who famously described goodwill as, among other things, 'the attractive force which brings in custom':

> What is goodwill? It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation, and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old-established business from a new business at its first start. The goodwill of a business must emanate from a particular centre or source. However widely extended or diffused its influence may be, goodwill is worth nothing unless it has power of attraction sufficient to bring customers home to the source from which it emanates. Goodwill is composed of a variety of elements. It differs in its composition in different trades and in different businesses in the same trade.[36]

Justice Warrington added to the debate when in *Hill v Fearis*[37] he described goodwill in terms of the advantages of continuity:

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32 See *Joseph Story and John C Gray, Story on Partnership*, Chapter VI § 99, 170 (Little, Brown & Co, 6th ed, 1868).
33 149 US 436, 446 (1893).
34 [1901] AC 217.
35 Ibid 235.
36 *Muller* [1901] AC 217, 223-224.
37 (1905) 1 Ch 466.

> … the goodwill of a business is the advantage, whatever it may be, which a person gets by continuing to carry on and being entitled to represent to the outside world that he is carrying on a business which has been carried on for some time previously.[38]

Despite the fact that judicial concepts of goodwill emphasised the inseverable nature of goodwill for legal purposes, by the mid-1930s some judges were classifying goodwill into composite parts based upon the kind of customers likely to be attracted to a business. A particularly colourful classification was recited by Maugham LJ in *Whiteman Smith Motor Co Ltd v Chaplin*[39] and referred to by Rich J of the Australian High Court in *Federal Commissioner of Taxation v Williamson*[40] where his Honour said:

> Now, customers vary. In Whiteman Smith Motor Co. Ltd. v. Chaplin the types were zoologically classified into cats, dogs, rats and rabbits. The cat prefers the old home to the person who keeps it, and stays in the old home although the person who has kept the home leaves, and so it represents the customer who goes to the old shop whoever keeps it, and provides the local goodwill. The faithful dog is attached to the person rather than to the place; he will follow the outgoing owner if he does not go too far. The rat has no attachments, and is purely casual. The rabbit is attracted by mere propinquity. He comes because he happens to live close by and it would be more trouble to go elsewhere. These categories serve as a reminder that the goodwill of a business is a composite thing referable in part to its locality, in part to the way in which it is conducted and the personality of those who conduct it, and in part to the likelihood of competition, many customers being no doubt actuated by mixed motives in conferring their custom.[41]

Meanwhile, the Calcutta High Court undertook a rather poetic synthesis of goodwill's various attributes in *CIT* v *Chunilal Prabhudas & Co*[42] when it observed:

> … [goodwill] has been horticulturally and botanically viewed as 'a seed sprouting' or an 'acorn growing into the mighty oak of goodwill'. It has been geographically described by locality. It has been historically explained as growing and crystallising traditions in the business. It has been described in terms of a magnet as the 'attracting force'. In terms of comparative dynamics, goodwill has been described as the 'differential return of profit'. Philosophically it has been held to be intangible. Though immaterial, it is materially valued. Physically and psychologically, it is a 'habit' and sociologically it is a 'custom'. Biologically, it has been described by Lord Macnaghten in *Trego* v. *Hunt* [1896] AC 7 (HL) as the 'sap and life' of the business. Architecturally, it has been described as the 'cement' binding together the business and its assets as a whole and a going and developing concern.[43]

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38 Ibid 471.
39 [1934] 2 KB 35, 4.
40 (1943) 67 CLR 561.
41 Ibid 564
42 [1970] 76 ITR 566.
43 Ibid 577-78

The High Court of Australia made a further contribution to the goodwill jurisprudence in *Box v Federal Commissioner of Taxation (‘Box’)*[44] when after citing Lord Lindley in *Muller* with approval,[45] Dixon CJ, Williams, Fullagar and Kitto JJ it described goodwill broadly in terms of its value-adding attributes stating:

> [g]oodwill includes whatever adds value to a business, and different businesses derive their value from different considerations.[46]

The court spoke again in the latter part of the 20th century, emphasising in *Geraghty v Minter*[47] that although property in its own right, goodwill is not something which can be conveyed or held in gross; it is something which attaches to a business and cannot be dealt with separately.[48] However, this was expressly doubted by Hill J in *Commissioner of Taxation v Krakos Investments Pty Ltd* (‘*Krakos*’)[49] where, after referring to the statements of Lord Macnaghten in *Muller* that the goodwill of a business is one whole and that to exist it must be attached to a business, his Honour said:

> Whether this proposition is universally correct must be doubted. For example, a business may have both goodwill attaching to a name and goodwill attaching to premises. There seems no reason why each of these aspects of the goodwill of such a business could not be dealt with separately.
>
> The different aspects of goodwill that have been recognised in the cases include site goodwill, personal goodwill and name goodwill. There may also be other kinds of goodwill such as monopoly goodwill.[50]

In essence, Hill J was asserting that goodwill attaches to the specific item of property said to be its source and so may be dealt with only in conjunction with that property. Later in his judgment his Honour seemed to qualify this by stating that it may also be dealt with as a separate species of property or as being the subject of a bargain and sale at a price.[51] Hill J’s characterisation of goodwill as being capable of being split into various kinds, at least some of which could attach to the assets which were said to be their sources, was later expressly rejected by the majority in *Murry*.

What can be seen from this brief overview of the cases is that by the end of the 20th century, not only was there no universally accepted definition of goodwill for legal purposes, there was also ongoing judicial divergence concerning both its nature and its relationship with its sources.

Such was the state of affairs when the Federal Commissioner of Taxation appealed to the High Court of Australia against a decision of the Full bench of the Federal Court in *Murry*.

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44 (1952) 86 CLR 387.
45 Ibid, 396.
46 Ibid 396-397.
47 (1979) 142 CLR 177.
48 Ibid 181.
49 (1995) 61 FCR 489.
50 Ibid 496.
51 Ibid 502.

III. THE HIGH COURT OF AUSTRALIA IN *MURRY*

A. Background

In *Murry*, the issue before the High Court was whether the sale of a taxi licence and some shares in a taxi co-operative could convey goodwill so as to enliven a capital gains tax concession under the federal *Income Tax Assessment Act* 1*936* (Cth) (‘*ITAA*’). The *ITAA* did not define ‘goodwill’ and therefore the High Court's comments relate to goodwill in its common law context and are of general application.

The facts of the case are that in 1987, Mrs Murry and her husband conducted as partners what was described as a taxi business. The business at that stage consisted of a single taxi, the licence for which had been purchased on the open market. In November 1987, the partners acquired a second taxi licence from the Queensland Department of Transport upon the payment of the sum of $85,000. They also acquired shares in Suncoast Pty Ltd which were valued at $15,000. The partnership leased the taxi licence to Mr Gower for a monthly fee. Mr Gower owned the vehicle which had the benefit of the partners' licence. In March 1992, the partners sold this second licence and the shares in Suncoast Pty Ltd to a Mr and Mrs Wilkins. At the same time, Mr Gower sold his vehicle to them. The ‘contract of sale’ was on a form issued by the Department which was headed: ‘Application for Transfer Licence/s to Hire Taximeter Cab’. In the form, the $220,000 sale price was divided up as follows:

Sale price vehicle	$ 6,000
Shares	$ 25,000
Goodwill (Licence Value)	$189,000
Total sale price	$220,000

An entry in the form identified Mr Gower as the owner of the vehicle.

Item 4 was headed ‘Transferee/s’ and contained an application by Mr and Mrs Wilkins ‘for the transfer to me/us of licence/s to hire as detailed in Item 2 of this application’. As a result of this transaction and after taking into account the index provisions of the *ITAA*, the partnership realised a capital gain of $6,130 on the shares and $72,071 in respect of the licence. Mrs Murry's share of the capital gain on the licence was $36,036. In her income tax return for the year ended 30 June 1992, she claimed that this sum was a receipt for the sale of the goodwill attaching to the licence and that, in accordance with s 160ZZR of the *ITAA*, she was entitled to a 50 per cent reduction of the capital gain. The Commissioner rejected her claim.

Mrs Murry appealed to the Administrative Appeals Tribunal which upheld her appeal. The Commissioner subsequently appealed to the Full Court of the Federal Court and when he was unsuccessful, appealed to the High Court.

B. Why the High Court granted special leave to appeal

The High Court's willingness to hear the case was not unusual given the uncertainty which existed at the time regarding the legal doctrine of goodwill and the relevance of goodwill to taxation matters in Australia. In his 2010 article, 'Goodwill and Taxation Issues', Michael Walpole attributes this relevance to three influences.[52] The first he says is due to the former imposition of income tax on premiums paid by lessees on entering into a lease.[53] Prior to the removal of these transactions from the scope of income tax into the capital gains tax rules in 1985, taxpayers argued that certain payments made at the commencement of some leases were payments for goodwill (and capital in nature) not premiums subject to income tax.

The second is that in some Australian states, goodwill transferred between taxpayers was assessable to stamp duty and so the identification and value of the goodwill was often in issue. The third influence Walpole identifies came about during the period between the introduction of capital gains tax in Australia in 1985 and its subsequent reform in 1999 at which time the meaning of the term 'goodwill' was important in the application of capital gains tax to disposals of goodwill of small businesses in Australia on account of the relief provided under s 160ZZR of the *ITAA*. It was Mrs Murry's entitlement to such relief which fell to be determined by the High Court.

There was also a fourth influence, although Walpole does not mention it in his article. This was the introduction by the various states of land rich provisions into their duties legislation in the latter half of the 1980s. The legislation was originally an anti-avoidance measure designed to address a perceived loophole in the duties legislation which required that a purchaser of land pay stamp duty at *ad valorem* rates, but a purchaser of shares in the entity which held the land (and little or nothing else), pay duty at the much lower share transfer rates. The land rich provisions were intended to close the loophole by requiring that the purchaser of a majority interest in a land rich entity pay *ad valorem* duty on the value of the land held by the company. An entity was land rich if it owned land in the relevant State above a certain threshold value, and if the value of its land wherever situated represented 80% or more of the value of all of the property to which the entity was entitled. This required taxpayers and taxing authorities to identify and value all of the entity's property (including its land) and determine what percentage of its total property was comprised of land.

Whether or not an entity had property in the form of goodwill, and whether that goodwill inhered in its land or was property in its own right was important. If the former was true, this would increase the value of the entity's land and along with it, increase the prospect of it being found to be land

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[52] Michael Walpole, 'Goodwill and Taxation Issues' [2010] *UNSWLR* 49.

[53] See for example, s 83 of ITAA and also s 26AB applicable to assignments of leases granted before 20 September 1985.

rich. However, if the goodwill was property in its own right and did not inhere in or enhance the value of the entity's land, this decreased the likelihood of the entity being found to be land rich. While *Murry* was not a land rich case, in the years since it was handed down, it is in this context that its reasoning and ratio has been most vigorously contested; both by Commissioners seeking to impose duty, and by taxpayers hoping to avoid it.

In any event, the High Court granted special leave to the Federal Commissioner to appeal against the Full Federal Court's decision and on 6 November 1997 the appeal was argued before a High Court bench comprised of Justices Gaudron, McHugh, Gummow, Hayne and Kirby.

C. The majority judgment

A majority comprised of Justices Gaudron, McHugh, Gummow and Hayne (Kirby J dissenting) upheld the Commissioner's appeal disagreeing with the Administrative Appeals Tribunal (and a majority of the Full Federal Court which upheld its decision) that 'the taxi licence was so intimately connected with the business as to constitute part of the goodwill of the business'.[54] Rather, the majority found that the transaction did not involve the sale of any business, and without a business there could be no transfer of goodwill. In reaching its decision, the majority examined the existing authorities and made a number of important statements concerning the nature, existence and value of goodwill for legal purposes.

1. Goodwill is property and an asset in its own right

Perhaps the majority's most important statement was its confirmation that goodwill is property and an asset in its own right[55] and for this reason, does not inhere in the other assets of the business.[56] Their Honours conceded that some authors assert that jurisprudentially, goodwill is not property, but rather is a quality or attribute of property, in the sense that 'value' is such a quality or attribute. They disagreed saying that 'the question whether goodwill is property must be taken as settled in favour of the view that it is'.[57]

The justices also emphasised that properly understood, goodwill could not be separated into component parts attaching to specific assets and criticised Hill J's characterisation of goodwill as site goodwill, personal goodwill, name goodwill and monopoly goodwill in *Krakos.*[58] They conceded that in particular contexts, descriptions of this kind may be helpful in identifying, for example, where goodwill is sourced from, care must be taken to avoid seeing these descriptions as separate items of goodwill, which despite the descriptions, remains one whole item of property.[59] Further, in their

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54 *Murry v Federal Commissioner of Taxation* (1995) 32 ATR 1091, 1093 [24] (Deputy President Dr P Gerber).

55 'Goodwill is an item of property and an asset in its own right. For legal and accounting purposes, it must be separated from those assets and revenue expenditures of a business that can be individually identified and quantified in the accounts of a business.' *Murry* (1998) 193 CLR 605, 617-618 [30].

56 Ibid 626 [53].

57 Ibid 617 fn 44.

58 Ibid 620 [36].

59 Ibid 620 [37].

Honours' view, Justice Hill's characterisation of goodwill as being attached to particular assets confused the concept of goodwill as property with its sources, and did not distinguish between the potential use value of an asset of a business, and the goodwill of the business that is derived from the use of that asset.[60] They said that pushed to its logical conclusion, it must mean that goodwill was not an asset but a series of assets that inhered in the other assets of a business. This conclusion contradicted the two fundamental premises of the law of goodwill; that goodwill had no existence independently of the conduct of a business, and that goodwill could not be severed from the business which created it. Their Honours pointed out that '[t]hose premises had been accepted as fundamental by the House of Lords and by the High Court of Australia, and that, statute apart, it was too late for them to be now called in question.'[61]

The majority acknowledged that some accounting writers argue that goodwill has meaning only in so far as it describes the benefits flowing from such immeasurables as good business management and the lack of competition by reason of monopolistic privileges. They said on this theory, most of the attributes of goodwill attach to specific assets and gave examples of a favourable location affecting the value of land, or the reputation of a business being inseparable from its trademarks and trade names.[62] However, with the possible exception of some compensation cases, they pointed out that nothing in the case law supported the proposition that the goodwill of a business is divisible and can be transferred either in gross or as part of the transfer of an asset.[63]

In relation to these compensation cases, the justices conceded that in some cases involving licensed premises, statements can be found that might suggest that the goodwill of a business is inseparable from the land upon which the business is conducted. However, they said that cases such as *Minister for Home and Territories v Lazarus*[64] and *Commonwealth v Reeve*[65] do not support and indeed deny that the site goodwill of a business can be transferred without also transferring the business.[66] In the majority's view, the compensation cases establish that although the value of the goodwill of a business sourced from its site may be a persuasive guide to the value of the land on which the business is conducted, it is the potential use of the land (including its potential to be used to conduct a business of the kind situate on it) and not the goodwill derived from using the land that is valued in compensation cases concerned with the compulsory acquisition of that land.[67]

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, but it does not involve the disposition of that goodwill or any part of it.[68] This is because at law, goodwill inheres in and is inseparable from the business itself and not the

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60 Ibid 618-619 [33].
61 Ibid 620 [36].
62 Ibid.
63 Ibid 620 [37].
64 (1919) 26 CLR 159.
65 (1949) 78 CLR 410.
66 *Murry* (1998) 193 CLR 605, 621 [38].
67 Ibid 622 [40], 623 [43].
68 Ibid 618 [32].

assets from which it is sourced. Unless a business is also transferred along with the asset, the transfer of the asset does not transfer any part of the goodwill of the business.[69] For this reason, the sale of an asset of a business does not involve any sale of goodwill unless the sale of the asset is accompanied by or carries with it the right to conduct the business in which it is presently used.[70] That being said, the potential use of the asset which is transferred out of the business may give it a value which approximates the value of the goodwill which the business may have derived from using the asset. Even so, the potential use of an asset and the goodwill of a business are not to be equated for legal purposes.[71]

2. Goodwill in a legal sense exists as a bundle of rights

It follows from the majority's affirmation of goodwill as property, that like other property, goodwill exists as a bundle of rights and privileges. The majority identified these rights and privileges as including:

(a) 'the 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';[72]

(b) 'the right or privilege to make use of all that constitutes the `attractive force which brings in custom';[73]

(c) 'the right to use the other assets of the business as a business to produce income';[74]

(d) 'the right to receive income without interruption despite a change of ownership';[75] and

(e) 'the legal right or privilege of the proprietor of a business to conduct the business in a particular way and by particular means'.[76]

Importantly, the majority said that what follows from this is that a person necessarily acquires goodwill when he or she acquires these rights and privileges, even if the sources of the business's goodwill subsequently change or diminish or increase in importance. In this way, the majority distinguished between the *existence* of goodwill, which it said depends upon proof that the going business generates and is likely to continue to generate earnings,[77] and the *sources* of goodwill from which those earnings are directly or indirectly generated from time to time.

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69 Ibid 618 [31].
70 Ibid 617-618 [30].
71 Ibid 619 [33].
72 Ibid 619 [23].
73 Ibid.
74 Ibid.
75 Ibid.
76 Ibid 617 [30] fn 44.
77 Ibid 611 [12]. Note that although the majority use the term 'earnings', they do not use it in a technical sense such as to restrict it to notions of profit. Rather, their Honours make it clear subsequently in their reasons that profitability is not a pre-requisite to the existence of goodwill for legal purposes: See 614 [20] and 624-625 [50]. As

> 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. 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. [footnotes omitted].[78]

3. Patronage has been rejected as the touchstone of goodwill in favour of the added value concept

Earlier in this thesis, a review of the authorities showed how the legal concept of goodwill had undergone a significant transformation in the 20th century moving away from mere customer loyalty to encompass all manner of value-adding attributes of a business. Yet despite this, custom was still an essential ingredient in the legal mix. All of the justices in *Murry* recognised this including Justice Kirby who in his dissenting judgement made the following observation:

> Over the course of this century, from an "initial focus on maintaining customer relations"[79] the concept of goodwill, in judicial elaborations, has gradually developed. It has expanded in "breadth, complexity and level of abstraction".[80] Yet for all that, such expositions usually come back to common themes of "goodwill" as involving an intangible form of personal property that is somehow connected with bringing in custom. [81]

The majority agreed, observing that the courts had rejected patronage as the touchstone of goodwill in favour of the added value concept,[82] although this didn't necessarily mean that a business without excess value had no goodwill. This is because the attraction of custom still remains central to the legal concept of goodwill and courts will protect this source or element of goodwill irrespective of the profitability or value of the business.[83]

Reconciling these two themes, which are repeated throughout the majority's reasons, is not easy. On one hand, there is no question that custom is essential to a business and it is plain that no business can continue to operate and generate revenue without it. On the other hand, custom, including repeated custom, is of little utility if it fails to generate earnings or otherwise add value. Similarly, a business may possess other attributes which generate earnings or add value yet have

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such, 'earnings' should be read more expansively in terms of revenue or income: See also 616 [27] whether the majority use the term 'revenue' rather than 'earnings'.

78 Ibid 623 [45].
79 CJ Taylor, *Capital Gains Tax: Business Assets and Entities* (LBC, 1994) 205.
80 Ibid.
81 *Murry* (1998) 193 CLR 605, 633 [81].
82 Ibid 614 [20].
83 Ibid.

little or no obvious attraction for customers. Examples among many include a clever and efficient plant configuration, good industrial relations with employees or a good safety record.

So what did the majority mean when they described patronage as having been ‘rejected’ in favour of the added value concept while the attraction of custom remained central to the legal concept of goodwill? Arguably, what the judges meant was that a business’s value is not determined solely by its customer relationships, but extends to all manner of positive advantages and attributes which combine to give the business its attractive force and which result in earnings being generated or value being created.[84] Some of these advantages and attributes may directly or indirectly attract customers to deal with the business, while others may not. Some may generate earnings or create value in their own right while others will do so only in combination with other advantages or attributes, or by assisting to create advantageous circumstances or business conditions which allow the business to increase or maintain its earnings or decrease or maintain its costs. For these reasons, while patronage or custom is essential to any business, and the right to deal with the business’s past customers is an important source of goodwill, it is not the only source of goodwill in a business, and as such, can no longer be described as the ‘touchstone’ of the legal concept of goodwill.[85]

4. The rights-based legal definition of goodwill differs from the value-based accounting definition

The majority observed that conceptually, goodwill in a legal sense differs from goodwill in an accounting sense. This is because unlike the accounting concept of goodwill, the legal concept has three separate dimensions or aspects which combine to give it definition. The majority identified these dimensions or aspects as property, sources and value, and said that what unites them is the conduct of a business.[86]

In contrast, accounting and business conceptions of goodwill emphasise the necessity for the business to have some value over and above the value of its identifiable assets.[87] The Australian Accounting Standard which applied in 1992 when the Murrys sold their taxi licence was AASB 1013 *Accounting for Goodwill* under which goodwill was described as ‘the future benefits from unidentifiable assets which, because of their nature, are not normally individually recognised’.[88] AASB 1013 cited market penetration, effective advertising, good labour relations and a superior operating team as examples of these unidentifiable assets. Other intangible assets such as

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84 *Churton v Douglas* (1859) Johns 174 (Wood V-C); *Trego v Hunt* [1896] AC 7 (Lord Herschell); *Muller* [1901] AC 217 (Lord Lindley).

85 *Murry* (1998) 193 CLR 605, 614 [20].

86 Ibid 614-615 [22].

87 Ibid 614 [21].

88 AASB 1013 *Accounting for Goodwill* [5.1.1]. This standard has now been superseded and *AASB 138 Intangible Assets*, AASB 136 *Impairment of Assets* and AASB 3 *Business Combinations* now cover the accounting treatment of goodwill. In AASB 136, goodwill is described as ‘an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised’.

patents, licences, rights and copyrights do not qualify as unidentifiable intangible assets because they are capable of being both individually identified and separately recognised.[89] The future benefits from unidentifiable assets are conveniently measured as the difference between the acquisition price of a business and the fair value of its identifiable net assets.

Because goodwill for legal purposes includes ‘everything that adds value to the business’ and ‘every possible advantage’, any or all of the assets, attributes and advantages of a business may be sources of its goodwill, whether tangible or intangible; identifiable or unidentifiable. Goodwill as property stems from the owner's legal right or privilege to use all of these assets, attributes and advantages to conduct the business and earn income.

Accounting concepts of goodwill are more restrictive in that they have traditionally focussed on a more limited class of assets as the sources of goodwill, namely unidentifiable assets. Presumably, this has occurred because accountants are primarily concerned with documenting the purchase consideration for a business which involves allocating values to all of its identifiable assets and measuring goodwill as the residual difference between the value of those assets and an objective and reasonably available measure of the value of the business, i.e. its purchase price. On this basis, it is logical to explain the value of goodwill as the value of the unidentifiable assets of the business. Even so, while accounting standards specify that goodwill is an asset regardless of whether it has been purchased in an arms-length transaction or generated internally, they do not permit a business to record internally generated goodwill (as opposed to purchased goodwill) in its accounts on the basis that the requisite objectivity and reliability standards for internally generated goodwill are not met.[90] This of course does not mean that the business has no goodwill unless and until the business is sold. It merely means that it cannot be conveniently measured unless and until this occurs.

5. Goodwill is legally distinct from its sources which may or may not be property

The majority observed that although goodwill may have its source in any or all of the assets of a business, goodwill is legally distinct from its sources and cannot be severed from the business which created it.[91] Examples of potential sources of goodwill given by the majority include:

(a) identifiable assets; [92]

(b) locations; [93]

(c) people; [94]

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89 Ibid.
90 Ibid 5.1.2.
91 *Murry* (1998) 193 CLR 605, 608 [4], 620 [36].
92 Ibid 611 [12].
93 Ibid 615 [24].
94 Ibid 611 [12].

(d) efficiencies; [95]

(e) systems, processes and techniques of the business;[96]

(f) customers;[97]

(g) the way the business is conducted; [98]

(h) the personality of those who conduct the business; [99]

(i) the likelihood of competition; [100]

(j) competitive prices; [101]

(k) the tangible, intangible and human assets of the business;[102]

(l) manufacturing and distribution techniques; [103]

(m) the efficient use of the assets of a business; [104]

(n) superior management practices; [105]

(o) good industrial relations with employees;[106]

(p) lack of competition resulting from an enforceable restrictive covenant;[107]

(q) the existence of statutory monopolies such as patents or trademarks.[108]

(r) expenditure including funds expended on advertising and promotions, wages, labour relations and customer service;[109] and

(s) imperfect or inefficient competition or extensive market penetration.[110]

It is evident from these examples that not all sources of goodwill are property for legal purposes or assets for accounting purposes and nor are they required to be.[111] What is also evident is that an

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95 Ibid.
96 Ibid.
97 Ibid 614 [20].
98 Ibid 615 [24].
99 Ibid.
100 Ibid.
101 Ibid 616 [24].
102 Ibid 615 [24].
103 Ibid 615 [25].
104 Ibid.
105 Ibid.
106 Ibid.
107 Ibid 616 [26].
108 Ibid.
109 Ibid 616 [27].
110 Ibid 616-17 [28].
111 Ibid 616 [25].

attribute of a business does not necessarily have to be capable (in itself) of attracting customers to the business in order to qualify as a source of goodwill.

6. The legal existence of goodwill does not depend upon the profitability of the business and does not require excess value

Unlike the accounting concept of goodwill, the majority stated that the legal existence of goodwill does not depend upon the business being profitable. For this reason, a business may have goodwill for legal purposes even when it is not profitable or where its value as a going concern does not exceed the value of its identifiable net assets.[112] This is because unlike the accounting concept of goodwill which requires excess value in order to exist, or at least be recognised as existing; in legal terms, goodwill exists as a bundle of proprietary rights which the law will recognise and uphold whether or not they result in the business having excess value. The majority made this clear when they stated:

> A business may have goodwill for legal purposes even though its trading losses are such that its sale value would be no greater than its 'break-up' value. Once the courts rejected patronage as the touchstone of goodwill in favour of the 'added value' concept, it might seem impossible for a business to have goodwill for legal purposes when its value as a going concern does not exceed the value of the identifiable assets of the business. But the attraction of custom still remains central to the legal concept of goodwill. Courts will protect this source or element of goodwill irrespective of the profitability or value of the business. Thus, a person who has sold the goodwill of a business will be restrained by injunction from soliciting business from a customer of the old firm even though the value of that firm is no greater than the value of its identifiable assets.[113]

It was because the majority considered that goodwill could exist for legal purposes without the excess value required by accountants, that they considered that Justice McHugh's description of goodwill in *Hepples v Federal Commissioner of Taxation*[114] as '… the collective name for various intangible sources of the earnings of a business which are not able to be individually quantified and recorded in the accounts as assets of the business'[115] was not to be regarded as an accurate statement of the legal definition of goodwill.[116]

7. Goodwill may typically be valued by the traditional accounting method

Having distinguished between legal and accounting concepts of goodwill, the majority observed how the goodwill of a business may typically be valued for both legal and accounting purposes. The justices said that in the case of a business that is profitable and is expected to remain profitable, the value of its goodwill can usually be calculated using the conventional accounting approach. This involves measuring the 'excess value', i.e. the difference between the net present value ('NPV') of

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112 Ibid 614 [20].
113 Ibid. Also *Pearson v Arcadia Stores Guyra Ltd* (1935) 53 CLR 571.
114 (1992) 173 CLR 492.
115 Ibid 542.
116 *Murry* (1998) 193 CLR 605, 614 [21].

the predicted earnings of the business (or the arms-length sale price of the business if such a price exists) and the fair value of its identifiable net assets; although in a legal inquiry, this requires that the identifiable assets be valued with some precision. This is because particular assets, as shown in the books of the business, may be under or overvalued and may require expert revaluation.[117]

In most cases, this could readily be achieved using a comparable sales or depreciated replacement cost ('DRC') approach. However, in some cases, such as where one or more of the assets is unique or where there is no evidence of comparable sales, this may not be possible and a different approach will be called for. One such an approach, the restoration method, will be discussed later in this thesis.

In the case of an unprofitable business, the majority conceded that its goodwill may be hard to assess. They suggested that perhaps one way to value it may be to measure 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.[118] The difficulty with this approach is that it assumes that the advantages possess discrete or readily ascertainable revenue streams, when in many if not most cases they do not and it is all of the assets and advantages of the business working together which typically produce the business's income.

8. The relationship between earning power and goodwill

Finally, the justices pointed out that even where a particular asset of a business has specific earning power, its earning power is unlikely to equal the earning power of the business itself. Presumably this is because if the earning power of the asset did equal the earning power of the business, the business would be redundant and its owner would be better off closing it down and selling or renting out the asset rather than incurring the time, costs and risks associated with running the business. The fact that he or she does not and continues to operate the business suggests that the two earning powers are not equal and for this reason, even if the particular income generating asset is sold, provided the business continues to operate it will continue to have goodwill, although perhaps of lesser value.[119]

The majority's abstract consideration of the value of goodwill of a business that essentially had a trade mark as its only key asset was designed to make the point that if the earning power of the business has been largely factored into the valuation of the trademark, and by implication the value of the business as a going concern, then the goodwill of the business should not be valued so as to similarly incorporate that same earning power. To do otherwise would be to engage in double

117 Ibid 624 [49].
118 Ibid 624-25 [50].
119 Ibid 625 [51]-[52].

counting.[120] It is unlikely that their example was intended to suggest that the earning power of an asset could be arbitrarily translated from one asset to another.

For all of these reasons, the majority observed that the value of the goodwill of a business is tied to the fortunes of the business and varies with its earning capacity and the value of the business's other identifiable assets and liabilities. It is seldom constant for other than short periods.[121]

D. The conclusion

In upholding the Commissioner's appeal, the *Murry* majority found that a taxi licence is simply an item of property whose value is not dependent on the present existence of a business. It is not and does not contain any element of goodwill. In so far as the licence gave its holder a right to conduct a taxi business, that business was conducted by Mr Gower and not by the Murrys. For this reason the sale of the licence and shares did not involve any sale of goodwill because they were not accompanied by and did not carry with them the right to conduct any business being carried on by the Murrys. Or put another way, the Wilkins did not acquire any right or privilege to make use of all that constituted the attractive force of the Murrys' business to generate earnings or otherwise create value. They simply acquired a licence which permitted them to start their own business with its own attractive force. For this reason also they did not acquire any goodwill when they acquired the licence and shares.

IV. THE INITIAL STRUGGLE TO APPLY *MURRY*

Despite the High Court's attempt to bring clarity to the subject, *Murry* was soon to become both sword and shield in a continuing battle over the legal concept of goodwill; most frequently in the context of a contested stamp duty assessment where the existence, nature and value of goodwill was often determinative. In the eyes of the various Commissioners of State Revenue, although *Murry* had stated that goodwill was indivisible, this did not prevent what Hill J had referred to in *Krakos* as 'site goodwill' from being included in the value of land to be assessed to duty. Taxpayers disagreed, pointing out that the *Murry* majority had expressly disapproved of his Honour's characterisation and stated that goodwill is not part of and does not enhance the value of the asset from which it is sourced, but is a separate asset in its own right. They argued that while land or other property must be valued on the basis of its highest and best use, including any reasonably achievable *potential* use, the Commissioner was not permitted to simply re-badge 'site goodwill' as 'potential use value' and add or include it in the value of the land.

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120 Ibid.

121 Ibid 624 [48].

A. Kizleap

One of the first in a series of cases in which various versions of these arguments were advanced *was Kizleap Pty Ltd v Chief Commissioner of Stamp Duties* ('*Kizleap*')[122]. In *Kizleap*, Adams J considered whether a sale of shares of a company owning land upon which it operated a caravan park business was subject to land rich duty under the *Stamp Duties Act 1920* (NSW). It was common ground that the two principal assets of the company were its land and the goodwill associated with the business. The Commissioner contended that most of the goodwill was in the nature of 'site goodwill' and should be included in the value of the land. If this was done, the value of the remaining 'personal goodwill' was less than 20% of the value of the company's total property and so the 80% land rich threshold was met. The taxpayer disagreed asserting that the personal goodwill was sufficiently valuable to defeat the test.

Justice Adams referred to *Murry* and the earlier case of *E.I.E Ocean B.V v Commissioner of Stamp Duties* ('*E.I.E Ocean*'*).*[123] He noted Pinkus JA's observations in *E.I.E Ocean* that there is a distinction to be drawn between 'personal goodwill' and 'site goodwill', and that only the latter could properly be included in the value of land.[124] He observed that the majority in *Murry* had made the point that although the cases concerning goodwill refer to site goodwill, personal goodwill, name goodwill and monopolies giving rise to goodwill, these descriptions reflected the questions arising in particular contexts and did not demonstrate that the goodwill of a business is divisible and can be transferred in gross or as part of the transfer of an asset.[125]

Nevertheless, Adams J still purported to apportion the business's goodwill into personal or name goodwill and site goodwill and value them separately in order to include the site goodwill in the value of the land.[126] His Honour found that the value of the personal or name goodwill was sufficiently high to prevent the value of the land from exceeding 80% of the value of the taxpayer's total property[127] and so he upheld the taxpayer's appeal.

Although the outcome in *Kizleap* may have been correct, Adam J's reasoning is contrary to *Murry*. First, because notwithstanding the majority's disapproval, he purported to divide goodwill into composite parts; and second because he then attempted to separately value those parts and attribute their value to the source asset itself; in this case, the land. In doing so, his Honour split what is the indivisible proprietary asset of goodwill and treated it, in point of fact if not in law, as attaching or adhering to the individual assets of the business.

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122 [2001] NSWSC 80.
123 [1998] 1 Qd R 36.
124 *Kizleap* [2001] NSWSC 80 [14] quoting *E.I.E Ocean* [1998] 1 Qd R 36, 47; In *E.I.E Ocean*, the Queensland Court of Appeal ruled that unlike site goodwill, personal goodwill could not be included in the value of land because it attaches to the proprietor and not to the land. Judgment was delivered by the Court on 17 December 1996 well before *Murry* came before the High Court.
125 *Kizleap* [2001] NSWSC 80 [16].
126 Ibid [37].
127 Ibid [40].

It is possible that Adams J was in substance attempting to equate site goodwill with the 'potential use value' of the land as the latter term was used by the majority in *Murry*.[128] However, while the majority did concede that in some circumstances, the potential use of an asset may give it a value which approximates the value of the goodwill which the business may have derived from using the asset, the potential use of an asset and the goodwill of a business are not to be equated for legal purposes. This is because even if it was permissible to apportion the value of goodwill amongst its sources, which the High Court said it is not, such an apportionment would be arbitrary at best given that it is the assets and attributes of a business working together which produce goodwill in a legal sense.[129]

B. Uniqema 1

Next in the series of cases to apply *Murry* was *Uniqema Pty Ltd v Commissioner of State Revenue* ('*Uniqema 1*').[130] The case involved the sale of land and a chemical manufacturing business which was conducted on the land. The Commissioner argued that as a key asset of the business was a factory which was located on the land, the goodwill of the business was therefore derived from using the land. What followed was that this site related goodwill should form part of the value of the land for assessment purposes.

Pagone J rejected the Commissioner's submissions on the basis that the business's goodwill was not local to the land because the business did not draw custom from the location of the land. For this reason, the goodwill was attached to the business and not the land and therefore did not form part of the value of the latter.[131] His Honour's reasons indicate that he accepted that site goodwill is a species of goodwill which attaches to and forms part of the value of land. Like Justice Adams in *Kizleap*, Justice Pagone may have reached the right result for the wrong reason as his reasoning is in direct conflict with that of the majority of the High Court in *Murry*.

C. Morvic

Three days after he delivered his reasons in *Uniqema 1*, Justice Pagone handed down his decision in *Morvic Pty Ltd v Commissioner of State Revenue* ('*Morvic*').[132] The case concerned the sale of a motel business and the land upon which it operated. The sale of the business and the land were documented separately. The contract to sell the business allocated a small amount of the purchase price to the chattels of the business with the balance of $1.3 million allocated to goodwill.

The Commissioner submitted that when land and a business are sold in the same transaction to the same purchaser, the value of so much of the goodwill of the business as has its source in the land

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128 Although Adams J referred to it as 'highest and best potential use' perhaps confusing 'potential use' with the valuation principle of 'highest and best use', nothing turned on this as the two are arguably synonymous.

129 See *Murry* (1998) 193 CLR 605, 615 [23]-[24], 620-21 [34]-[37].

130 (2002) 50 ATR 91.

131 *Uniqema* (2002) 50 ATR 91, 93 [3]-[4].

132 [2002] ATC 4459.

should be incorporated into the value of the land as if the goodwill were an element of the land itself. He claimed that the whole amount allocated to goodwill was in respect of site goodwill and so should be included in the assessable value of the land. Alternatively, the goodwill was a chattel and was dutiable along with the land.

Pagone J agreed with the Commissioner that site goodwill was dutiable and should be included in the value of land. He referred with approval to the decision of Mr Nettle QC in *Cresswell Nominees Pty Ltd v Commissioner of State Revenue* (‘*Cresswell Nominees*’)[133] in which Mr Nettle QC considered that ‘local or site goodwill was inseparable from the land on which a business is conducted and therefore in a sense passes with a transfer of land’.[134]

In Pagone J's opinion, Mr Nettle QC correctly emphasised the importance of the facts of each case to a determination of the question concerning the extent to which goodwill will inform or affect the value of land acquired in a transaction. In the present case, he found that it was critical that the purchaser acquired both the business and the land and considered that the outcome of the case may have been different had the business been acquired through a separate leasehold interest. In that case, he said that the goodwill of the business would have attached to the leasehold interest rather than the revisionary (freehold) interest.[135]

His Honour found that in the present case, the right to conduct the business was effectively transferred with the freehold, leaving nothing for the purchaser of the business to acquire.[136] This was because his Honour considered that the benefit of all of the elements of the goodwill was necessarily transferred to the purchaser of the land on its acquisition. He identified those elements as being:

(a) the location of the business;

(b) the community infrastructures surrounding the place of the business;

(c) the design and the condition of the improvements;

(d) the aesthetics of the improvements;

(e) the reputation of the business;

(f) the history of sales and the marketing of the business; and

(g) proprietor acumen.[137]

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133 (Unreported, VCAT, 7 November 2001).
134 Ibid [12].
135 *Morvic* [2002] ATC 4459, 4463.
136 Ibid 4461-62.
137 Ibid 4462.

Even if it were possible for all or any of first four elements to pass in law to a purchaser of land alone, how the benefit of the latter three can possibly do so without the purchaser also acquiring the business located on the land was not explained by his Honour. Nor does he explain how ownership of the freehold would give the freeholder the legal right or privilege to make use of all of the business's tangible and intangible property such as its liquor licence, name, contracts with suppliers, customers or employees, guest lists or preferences, book debts, inventory or chattels etc in order to conduct a motel business in substantially the same manner and by substantially the same means as the present owner of the business. None of these assets or attributes of the motel business passed in a legal sense to the freehold owner and if he or she had attempted to make use of them, the law would have protected the rights of business owner by injunction or other remedy.[138]

Pagone J considered that the burden of proving that some or all of the goodwill attaching to the business was not purchased with the land lay on the appellant and that it had failed to discharge that burden.[139] In these circumstances, he ruled that the whole of the agreed amount for goodwill could be taken into account by the Commissioner and taxed as land.

In many respects, Justice Pagone's reasons in both *Uniqema 1* and *Morvic* are consistent with the interpretation of *Murry* taken by Adams J in *Kizleap* in that he treats goodwill sourced from the location of a business as adhering to the land in question rather than the business – in fact if not in law. However, in *Morvic*, Pagone J took this a step further. First, he found that when land and a business conducted on land are sold in the same transaction to the same purchaser, the value of so much of the goodwill of the business as has its source in the land should be incorporated into the value of the land as if the goodwill were an element of the land itself. Second, he found that where the location of a business is its exclusive or primary source of goodwill, a transfer of the land will also convey the goodwill of the business being conducted on the land.

The Commissioner lodged an appeal against Justice Pagone's decision in *Uniqema 1* with the Victorian Court of Appeal although before the appeal was heard, Harper J of the Victorian Supreme Court handed down his decision in *Palace Hotel (Hawthorn) Pty Ltd v Commissioner of State Revenue* (Vic) ('*Palace Hotel*').[140]

D. Palace Hotel

Palace Hotel involved the sale of fee simple land on which a hotel was operated in accordance with a deed of compromise. The Commissioner conceded that as a matter of law, the transfer of land did not include the transfer of the goodwill in the business. However, he considered that the value of the land was enhanced by the goodwill of the hotel business conducted on the land to the full extent of the value of the business. He assessed stamp duty on the enhanced value of the land.

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138 *Murry* (1998) 193 CLR 605, 614 [20].
139 *Morvic* [2002] ATC 4459, 4463, 4464.
140 (2004) 8 VR 439.

The Commissioner relied on the decision of Mr Nettle QC (as he was then) in *Cresswell Nominees*, the same decision which had influenced Pagone J in *Morvic*. In *Cresswell Nominees*, Mr Nettle QC had referred to the propositions, re-affirmed by the High Court in *Murry,* that goodwill is in itself indivisible and is property which is inseverable from a business.[141] However, Mr Nettle had continued:

> For present purposes, however, the important point is not that goodwill is not divisible or that it has no existence independently of the business, but rather that, although it is indivisible and without existence independently of a business, some aspects of the goodwill will nevertheless affect the value of the land on which the business is conducted and others will not.
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> In some of the cases which precede *Murry* there is a tendency to treat goodwill as if it were divisible and thus to pose the question of how much if any of the goodwill passes with land. *Murry* makes plain that a purchase of land is not a purchase of goodwill and, as a matter of law, that the money which is paid for land is not money paid for goodwill. Nevertheless, to the extent that goodwill may be said to be annexed to land it will inform the amount which a potential purchaser is prepared to pay for the land and hence, in the valuation of the land, the value of so much of the goodwill as derives from the land may be considered in point of fact, though not in point of law, to be decisive of the valuation.[142]

The Commissioner argued that if the real property had been for sale on the open market, a potential purchaser would have been prepared to pay more for it than the mere value of the land and improvements, because in the circumstances of the case, acquisition of the ownership of the land carried with it the right to run the hotel business from the premises. Therefore, transfer of the ownership of the premises carried with it the opportunity to exploit the goodwill of the business.[143]

The appellant disagreed submitting that the land was the proper subject of the transfer not the goodwill of the business. It claimed that the land had been properly valued to reflect the fact that the business of an hotelier was being conducted on the land. The business carried on at that address was not transferred and so it was incorrect to add its value to the market value of the land.[144]

Harper J rejected the Commissioner's arguments and upheld the appeal saying this was not a case where immediately before the transfer, the ownership of the land carried with it the right to run the hotel business from the premises so that upon acquisition of the land that right was also acquired.[145] This was because the purchaser of the fee simple was in possession of the property as lessee and was the owner of the business conducted on the property. The purchase of the land therefore

141 Quoted in *Palace Hotel* (2004) 8 VR 439, 444 [21].
142 *Cresswell Nominees* (unreported, VCAT, 7 November 2001) [17]-[18] quoted in Ibid 445 [21].
143 *Palace Hotel* (2004) 8 VR 439, 442-43 [13].
144 Ibid 442 [12].
145 Ibid 443 [15]. Query whether this circumstance could arise in any event given that although premises may be licenced to permit the operation of a hotel business, other licences which are personal to the business owner or operator must also be obtained.

involved only the conveyance of the new interest, being the interest of an owner of fee simple of the land.[146]

He said that the applicable principle was that duty was payable on the sum of the amount for which the real estate might reasonably have been sold if it had been sold, free from encumbrances, in the open market on the date of sale. That amount was to include a component that accurately reflected the value to the owner of the freehold of the fact that the hotel business was conducted on the land. It did not include any amount for the business itself. That being so, it necessarily excluded any sum representing the goodwill associated with the business.[147]

His Honour disapproved in part Mr Nettle's statements in *Cresswell Nominees*, saying that it was unhelpful to speak of goodwill, the nature of which is indivisible and inseverable from a business, as being 'annexed' to land where the owner of the business may have no greater interest in the land than that of a tenant.[148]

Justice Harper also rejected the Commissioner's contention that the value of the real property was enhanced by the goodwill of the licensed hotel business which was conducted on the premises, because the goodwill had a number of sources which did not relate to the land. However, the value of the real property may have been enhanced by the fact that the business of an hotelier, one of the assets of which was its goodwill, was being conducted on the land and therefore generated rent for the owner of the reversion. An assessment of the value of the land could therefore include an amount to reflect the income generating capacity of the land.[149]

> I therefore accept that the value of real estate is increased if its ownership carries a secure income with it. A purchaser will pay more for a fully tenanted office building, with good tenants on long leases, than for an empty shell. Land on which a hotel is erected will attract a higher price if the business is well run, is conducted in a prosperous area, has an established clientele, and generates large profits, than if the opposite were true. The prosperous publican, if a lessee, will in those circumstances be anxious to retain the lease; and that anxiety will be reflected in the amount of rent that the business will generate for the owner of the land.[150]

His Honour pointed out that as the High Court said in *Murry*, the potential use value of the land must be distinguished from the goodwill associated with the business which may derive some source from the land:

> It is confusing to speak of goodwill that has its source, or part of its source, in the land, as enhancing the value of the land. That enhancement, if any, arises from the capacity of the land to produce income. It is no more (and no less) true to say that the value of… [the land] was enhanced by the

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146 Ibid 441 [5], 443 [14]. This would have been the case whether or not the purchaser was already in possession of the land as a lessee.
147 Ibid 445 [23].
148 Ibid 445 [22].
149 Ibid 444 [19].
150 Ibid 444 [18].

> goodwill of the business than it is to say that the worth of the land on which stands a large mid-city commercial building is enhanced by the collective value of the goodwill of the many separate businesses carried on within it. The land is valuable (or not) because it is (or not) attractive to prospective and actual tenants, and therefore likely (or unlikely) to generate correspondingly attractive (or less than attractive) rental income.[151]

For all of these reasons, his Honour found that the correct method of valuing the land was to capitalise a hypothetical rental for the land and improvements to arrive at a figure for the value of the real estate net of the operating business.[152]

Justice Harper's reasoning is consistent with that of the High Court in *Murry* and reflects the majority's understanding of both the separate and indivisible nature of goodwill for legal purposes, and the relationship between goodwill and the assets in which it has its source.

E. Uniqema 2

Shorter after Harper J delivered his reasons in *Palace Hotel*, the Victorian Court of Appeal delivered its reasons in *Commissioner of State Revenue v Uniqema Pty Ltd* ('*Uniqema 2*').[153] The Commissioner's appeal had several grounds. The first relied upon Justice Pagone's reasoning in *Morvic* that if the site on which a vendor's business was conducted at the time was the exclusive or primary source of the goodwill of the business sold to the taxpayer, the whole of the agreed value for goodwill should be added to the value of the land in order to determine the land's true value. Alternatively, the Commissioner argued that the fact that a business was carried on from a purpose-built factory added an element of goodwill value to the land itself whenever the land was sold together with that business.

The Court of Appeal dismissed the appeal, pointing out that *Murry* does not permit the indivisible asset of goodwill to be artificially apportioned between its sources. In his reasons, with which Phillips and Callloway JJA agreed, Ormiston JA warned that it was a dangerous simplification to conclude that it is necessary to look at each aspect of the enterprise to try rationally to apportion the goodwill of the enterprise among those sources. Such a division could never be accurate for each aspect of the enterprise must to a greater or lesser extent contribute to that intangible concept of goodwill which has no real existence except the value which the parties or others may put upon it either for selling, accounting, revenue or other like purposes.[154]

His Honour also counselled against picking on certain passages in the majority judgment in *Murry* saying that one can wrongly make generalisations out of particular examples. He said that if the Commissioner was right in his analysis of the case, then every business which was carried on at a

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151 Ibid 444 [20].
152 Ibid 445 [23].
153 (2004) 9 VR 523.
154 *Uniqema 2 (*2004) 9 VR 523, 540 [35].

site (perhaps including even a website) which was in any way adapted to its particular uses, even to the extent of having its name painted on the window or using a specific office layout, would have to concede that when sold with the business, the site somehow had an increased value by virtue of the vendor's goodwill; albeit that it would be impossible to attribute a specific part of the agreed goodwill price to that or any other asset or attribute of the business.[155]

His Honour warned that the cases of hotels and trademarks referred to by the majority in *Murry* are to be confined to their particular circumstances. He said that a trademark has special value because of the monopoly right to use that which is intended to designate a product or business. In most cases it would be almost impossible to separate the goodwill sourced from the trademark from the value of the trademark itself. As to hotels, his Honour observed that local or site goodwill only becomes relevant when the goodwill consists of the capacity to attract customers directly to come to the premises and because it is implicit in many sales of hotels that the vendor can be restrained from seeking directly to canvas the former customers. In those very few cases where a term is implied, such as in the sale of hotels, it is not even necessary to sell the business or goodwill explicitly in order to say that there is implicit obligation on the vendor not to canvas customers. His Honour warned that 'beyond that very special group of cases, no similar conclusions can be drawn and no value can fairly be attributed to site as contrasted with any of the many other factors which go to make up the successful enterprise which is sold'.[156]

Justice Ormiston said that in the present case, the actual business of selling the vendor's product was conducted away from the factory, not merely in terms of contact with customers but because no part of the selling of the product either took place on or was organised from the site. It was an entirely wholesale business which had neither trademarks nor any other get-up which was of significance to purchasers or attracted trade to it. The site was merely the place where most of its products were made, and so was no different from that used by a wholesaler, a chain retailer or any other business enterprise which would likewise see little purpose in selecting a specific office or other site in order to attract business. For this reason, neither the whole nor any part of the goodwill sold to the respondent formed part of or should be added to the improved value of the land.[157]

In dismissing the Commissioner's appeal, the Court found a proper value for the land would reflect the possibility that a prospective purchaser of the site might wish to manufacture the same or similar materials at the factory, but it would also have to take account of the real possibility that the factory would be of no use to some purchasers. The value added to the land by reason of the factory had nothing to do with goodwill, merely with its usefulness as the means of manufacturing certain chemical products.[158]

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155 Ibid.
156 Ibid 540-41 [36].
157 Ibid 541 [37]-[38].
158 Ibid 534 [21].

While the outcome of the case was undoubtedly correct, as with Justice Adams in *Kizleap*, there is a troubling aspect to Ormiston J's reasoning. While his Honour acknowledges that goodwill is property in its own right, distinct and separate from its sources, and acknowledges that it would be impossible to attribute a specific part of the agreed goodwill price to the land or any other asset or attribute of the business, ultimately his judgment seems to turn on the fact that the land was not a source of goodwill. The outcome may have been different if his Honour had found that the land was a source of goodwill, because in that event his reasoning indicates that he may well have considered that the goodwill formed part of and should be added to the improved value of the land.[159]

F. Primelife

Primelife (Glendale Hostel) Pty Ltd v Commissioner of State Revenue ('*Primelife*')[160] was the last in the series of Victorian cases in which the Commissioner sought to defend his interpretation of *Murry*. The presiding judge was Justice Harper who a month earlier had decided *Palace Hotel*. The case concerned the sale of two aged care facilities, the land on which the facilities were located, and the businesses themselves. In arms-length transactions Primelife (Glendale Hostel) Pty Ltd and Primelife (Cumberland Village) Pty Ltd purchased an aged care hostel (Glendale) and a combined retirement village and aged care hostel (Cumberland) respectively from the same vendor. In each case, two separate contracts were entered into; one for the land, buildings and improvements; and the other for the business conducted at the relevant facility.

In related transaction, Primelife Corporation Ltd, a company related to the purchaser companies, acquired certain allocated places in relation to which, under the *Aged Care Act* 1997 (Cth), the Commonwealth Government subsidised the provision of hostel accommodation and residential care for the elderly at Glendale and Cumberland.

The Commissioner asserted that the land, the chattels, the businesses and the allocated places were all to be assessed as part of the real property the subject of the relevant transactions. Alternatively, he argued that both the allocated places and the goodwill of the businesses were chattels the value of which must be brought to duty under s 63(3) of the *Stamps Act 1958* (Vic). The appellants submitted that neither the businesses (in which expression they included the goodwill generated by each business) nor the allocated places should be brought to tax. This was because they said neither were part of the real property acquired by Primelife (Glendale Hostel) Pty Ltd and Primelife (Cumberland Village) Pty Ltd. Nor were they, in any relevant sense 'chattels'.

Justice Harper found against the Commissioner saying that it was not appropriate to simply add the value of any goodwill which had its source in land onto the value of the land. Rather, what must be calculated and added to the value of the land is the monetary benefit (if any) to the owner of the

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159 Ibid 541 [37].
160 (2004) 9 VR 665.

land of the fact that the business was being conducted on it. Similarly, the value of the aged care places was not simply to be added to the value of the land, but was to be brought to account by calculating their benefit in monetary terms to the owner of the land as an element of its income-generating capacity. That benefit then becomes an element in the value of the real property.[161]

Justice Harper said that goodwill is not dutiable because it is not part of the land. Rather the duty implications for a transaction in which real property is sold to one purchaser, and the business conducted on it is sold to another, were clear. The transfer of land instrument was to be assessed for duty on the value of the land. His Honour conceded that that value will be affected, and perhaps in most cases be increased, by reason of the fact that a business is being conducted on the land, that the business is profitable, that it generates goodwill, and that the goodwill has its source at least in part in the land. But the ownership of the goodwill is inseparable from the ownership of the business. The one passes with the other, not in ‘a sense’ but in every sense.[162] The goodwill cannot therefore be brought to duty as if it were inseparable from the land, in the sense that it forms an element in or is a constituent part of the land. Its value cannot merely be cumulated with or added to the value of the land.[163]

His Honour was troubled by Pagone J's contrary finding in *Morvic* that the value of goodwill that has its source in land should be brought to duty by being cumulated with the value of the land on its sale.[164] He conceded that a number of authorities, both English and Australian, were to the effect that all or at least substantially all of the goodwill which attaches to the business of a public house is site goodwill. He also agreed that it was settled law that the sale or mortgage of hotel premises may involve the sale or mortgage of goodwill despite the absence in the contract of any reference to goodwill.[165] However, he said that while this might affect such issues as the burden of proof, Justice Pagone had cited no authority to support his finding in *Morvic* that it was the purchasers who bore the burden of establishing that the goodwill attaching to the business was not purchased with the land.[166]

Justice Harper said that the reasoning in *Uniqema 1* that goodwill is not calculated in the value of land where the land is not a source of the goodwill at all could equally be applied to a scenario where the land is one of a number of sources of goodwill. In these circumstances, so much of the value of the goodwill as does not have its source in the land should be excluded from the assessment of stamp duty.[167]

His Honour said that while it is appropriate to speak of goodwill that has its source, or part of its source, in the land as enhancing the value of the land - if (and to the extent that) it increases the

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161 Ibid 682 [53], 683 [55].
162 Ibid 679 [40].
163 Ibid.
164 Ibid 679-80 [38]-[42].
165 Ibid 678 [35]. But see *Uniqema 2 (*2004) 9 VR 523, 541 [36] (Ormiston J).
166 Ibid 678 [24], [34]-[35].
167 Ibid 676 [27].

capacity of the land to produce income - it is not appropriate simply to add the value of this goodwill onto the value of the land.[168] Rather, what must be calculated is the effect on the value of the land of the business that is being conducted on it; or, to be more precise, the income-generating capacity of the land.[169]

G. HSH Hotels

At a time when the Victorian and New South Wales Commissioners of State Revenue appeared to have exhausted their testing of the ambit of the *Murry* decision in the courts of their respective states, their South Australian counterpart was just getting started. The case in point was *HSH Hotels (Australia) Ltd v Commissioner of State Taxation (SA)* ('*HSH Hotels*')[170] and concerned the land rich provisions of the *Stamp Duties Act* 1923 (SA); provisions which were broadly comparable with those in Victoria and New South Wales.

The facts of the case are that HSH Hotels (Australia) Ltd ('HSH') acquired all the units in the Ramada Grand Hotel Unit Trust together with all shares in the corporate trustee. HSH sought the Commissioner's opinion on whether the transfer of the units in the unit trust for the nominal consideration of $1 (plus taking an assignment of some mortgages in the sum of $441,515,100) was assessable to duty. The Commissioner issued an assessment on the basis that HSH was land rich under section 100(2) of the *Stamp Duties Act* 1923. The assessment of the value of HSH's total property did not attribute any value to the goodwill associated with the hotel business. The Commissioner argued that there was no goodwill involved in the transaction because the business acquired was not the same as the business previously conducted, primarily because the agreement under which the hotel was managed was terminated. In addition, any goodwill associated with the business was shared, and as one of the entities sharing in the goodwill was not a party to the transaction no goodwill was transferred in the transaction. Further, and most importantly for present purposes, any goodwill was almost entirely related to the site and was therefore already taken into account in the value ascribed to the real estate.

The Commissioner took a 'top down' approach to valuation similar to that taken by the Queensland Commissioner in *E.I.E. Ocean.* In each case, the Commissioner started with the transaction value, deducted the non-land assets (excluding goodwill) and came up with an implied value of the land. As this implied value was more than 80% of the transaction value, the entity was land rich and the Commissioner assessed the land to stamp duty.

When HSH appealed to the Treasurer, the Treasurer obtained a further valuation of the land which was greater than the implied value. The assessment was increased to reflect the higher value.

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168 Ibid 675 [24].
169 Ibid 682 [53].
170 (2005) 58 ATR 276.

HSH appealed to the Supreme Court of South Australia on the grounds that there was a substantial amount of goodwill associated with the business and only a small amount of that goodwill was derived from the land. HSH argued that the Commissioner had failed to include the value of the goodwill of the business which was unrelated to the site in the value of the non-land assets which he deducted from the transaction value.

Anderson J rejected the Commissioner's contention that there was no goodwill associated with the business other than that derived from the site. He said that the fact that a large business was up and running and included considerable infrastructure, that there were probably advance bookings and that the hotel business was, in general terms, successful, would tend to indicate on the face of it that there was some goodwill involved.[171] He also found it likely that some goodwill attached to the conduct of the business and in the efficient use of the assets of the business, and was therefore transferred with the business in addition to the real property.[172]

However, in the absence of any evidence being led in relation to the significance of these non-land sources of goodwill, and because of the cessation of the management agreement (presumably negating any goodwill from that source), Anderson J found that the value of that non-site related goodwill was minimal leading to the conclusion that the acquired entity was land rich.[173]

In making this finding, Anderson J acknowledged the decision in *Murry*, yet endorsed the comments of Mr Nettle QC (as he was then) in *Cresswell Nominees* (a decision which was partly disapproved by Harper J in *Palace Hotel*).[174] According to Mr Nettle QC, the question of how much of any goodwill inheres in land and thus affects the value of the land is a question of fact. The question is to be answered in terms of how much an objective purchaser of the land would be prepared to pay for the opportunity of exploiting the land and, in turn, that means how much of any goodwill attaching to a business would the purchaser regard as attaching to the land rather than to other factors.[175]

Anderson J answered the question by finding that although there was a small amount of goodwill associated with the business, the majority of the goodwill was derived from the site itself and so was properly included in the value of the land.[176]

Anderson J considered the importance of the site to be analogous to the trademark example used in *Murry* saying:

> In my view, the site here can be compared with the trademark example, and both when valued may represent close to the whole value of a business. … [F]rom my reading of *Murry's* case, there should

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171 *HSH Hotels* (2005) 58 ATR 276, 294 [124].
172 Ibid 294 [125].
173 Ibid 295 [131]-[132].
174 Ibid 289 [98].
175 *Cresswell Nominees* (unreported, VCAT, 7 November 2001) [20].
176 *HSH Hotels* (2005) 58 ATR 276, 295 [132], 307 [230].

> be no distinction when considering either goodwill which derives from a trademark or goodwill which derives from a particular site.[177]

His Honour contrasted the factual circumstances of the case with the circumstances in *Uniqema, Primelife* and *Kizleap* saying the Victorian duty cases in particular illustrated how goodwill may be treated in different factual circumstances.[178] In each of those cases he said that the goodwill had a number of sources, including the site on which the business was operated. In contrast, in the present case, the goodwill of the business was derived almost wholly from its location.[179]

Justice Anderson considered that the nature of a business is critical to the question of whether it has significant non-site related goodwill. In essence, he found that if the earning power of a business is primarily attributable to its location, this will contribute to the value of the land and not the value of the goodwill of the business. This is because in his view, the value of the land may include a location specific benefit. The Commissioner's valuation method was preferred by his Honour because he said it acknowledged the importance of the location of the hotel and attributed a high rental value to the land. His Honour also agreed with the Commissioner's submission that the termination of the management agreement meant that only a small amount of goodwill was transferred with the business.[180]

With respect to his Honour, his reasoning is contrary to *Murry*. Rather than determine whether the case fell within the exception in *Murry* such that the right to conduct the hotel business effectively passed with a sale of the land; like Justice Adams in *Kizleap*, Justice Anderson thought it appropriate to determine the sources of the goodwill of the business and then apportion the goodwill between them as if it inhered in the sources rather than in the business itself. In Justice Anderson’s case, he was able to avoid the obvious practical difficulty associated with this task by finding that the location of the hotel was of such paramount importance that HSH could not legitimately come below the eighty per cent threshold.[181] Whereas in *Kizleap*, Justice Adams found the contrary to be true, accepting that so much of the goodwill of the business was sourced in the personality of its owner that it was sufficient to defeat the threshold.[182]

V. THE EMERGENCE OF THE ADDED VALUE AND PATRONAGE APPROACHES TO GOODWILL

A. From site goodwill to no goodwill

The cases discussed above demonstrate that despite the guidance offered by *Murry*, some courts were reluctant to depart from the practice of subdividing goodwill into component parts based upon

177 Ibid 293 [117]-[118].
178 Ibid 295-99 [133]-[154].
179 Ibid 294 [126], 295 [132].
180 Ibid 299 [154]-[155], 301 [171].
181 Ibid 307 [232].
182 *Kizleap* [2001] NSWSC 80 [40].

the assets said to be its source, and then allocating its value to those assets. Unsatisfactory as this practice was, it at least acknowledged that to a greater or lesser extent the business in question had goodwill. The real controversy concerned whether that goodwill passed in a sale of the asset said to be its source or otherwise enhanced the value of the asset. In each of the cases discussed, the asset in question was the land on which the business was located. By paying little more than lip service to *Murry*, most judges found that where the land was a source of goodwill, the goodwill passed with a sale of the land or at least enhanced its value. While some of the judges sought to avoid a confrontation with *Murry* by claiming that the goodwill passed with the land or contributed to its value 'in fact if not in law', this distinction without a difference was no doubt lost on the unfortunate taxpayer for whom the result was a hefty stamp duty assessment.

Then in 2007 the goodwill debate took a surprising turn when superior court judges from the Northern Territory and Western Australia delivered judgments which were to cast *Murry* in a whole new light. Like most of the previous decisions, the proceedings were appeals by taxpayers against significant assessments of stamp duty. However, what was extraordinary about the Northern Territory and Western Australian cases was the narrow interpretation of *Murry* pressed by the Commissioners and ultimately accepted by most of the judges. In a departure from the position taken by their Eastern States counterparts, rather than argue that the goodwill of the relevant business was site goodwill and so passed with or contributed to the value of the taxable land in question, both Commissioners denied that the taxpayer's business had goodwill of *any* kind because it lacked the requisite 'attractive force which brings in custom'.[183]

In the Northern Territory, the proceedings involved a first instance appeal by Alcan (NT) Alumina Pty Ltd to the Northern Territory Supreme Court against a decision of the Commissioner of Territory Revenue to assess its acquisition of shares to more than $47 million in land rich stamp duty and penalties in *Alcan (NT) Alumina Pty Ltd v Commissioner of Taxes* ('*Alcan 1*').[184] Although the Commissioner succeeded on the goodwill grounds, he failed on other grounds. He appealed those other grounds and the taxpayer cross-appealed the goodwill grounds to the Court of Appeal in *Commissioner of Territory Revenue v Alcan (NT) Alumina Pty Ltd* ('*Alcan 2*').[185]

In Western Australia, the proceedings were an appeal by Origin Energy Power Limited ('Origin') to the State Administrative Tribunal ('SAT') of Western Australia against a $6 million assessment of land rich stamp duty and penalties in *Re Origin Energy Power Ltd v The Commission of State Revenue* ('*Origin Energy*').[186] The President of the SAT heard and determined Origin's appeal with the benefit of the trial judge's reasons in *Alcan 1*, but before those reasons were reviewed by the Court of Appeal in *Alcan 2*.

183 *Murry* (1998) 193 CLR 605, 630 [68].
184 (2007) 208 FLR 159.
185 (2008) 24 NTLR 33.
186 (2007) 70 ATR 64.

In each case, the relevant duties legislation required the judges to first identify land held by the relevant company situated in the relevant state and if its value exceeded a certain threshold ($500,000 in the Northern Territory and $1 million in Western Australia), go on to identify and value all of the company's property and conclude whether the value of its land situated anywhere comprised more than 60% (Northern Territory), or 80% (Western Australia) of the value of its total property. If its land value equalled or exceeded those thresholds, the taxpayer was required to pay stamp duty at *ad valorem* rates on the value of the company's land and chattels, along with significant penalties for allegedly failing to comply with the disclosure obligations in the legislation. If the company's land value did not equal or exceed the threshold, the taxpayer had no liability to land rich duty or penalties at all.

Both Alcan and Origin argued (among other things) that the companies they acquired were entitled to substantial non-land property including goodwill of significant value. If accepted, this would result in the value of the relevant company's land being less than the required percentage and thereby relieve the taxpayer of the obligation to pay stamp duty. In each case, the relevant Commissioner argued that the company had little or no property in the form of 'legal goodwill' because the business it operated had no 'attractive force which brings in custom to the business'. Alternatively, each argued that the business had no 'accounting goodwill' because all of its value should be allocated to one or other of its identifiable assets.

As the cases wound their way through the judicial systems of the two states, a narrow and broad approach to the legal concept of goodwill emerged, each of which purported to find its authority in *Murry*. The cases will be discussed in some length shortly, but first it is convenient to summarise the two approaches.

B. The 'patronage' approach to goodwill

Under the narrow approach, 'legal goodwill' bears little or no relationship to the concept of goodwill as understood by accountants or business people generally. While 'accounting goodwill' describes the excess value in a business over and above the value of its identifiable assets, 'legal goodwill' is confined to 'the attractive force that brings in custom and adds to the value of the business'.[187] To have such a force, a business must sell a non-commodity product, and must possess assets or attributes which directly attract custom to the business. Such custom must also be of a particular kind being that of multiple customers who are unrelated to the proprietors of the business.[188] One judge favoured an even narrower approach by limiting the assets or attributes which attract custom to those specifically identified by the High Court in *Murry*; and further requiring that the business

[187] *Murry* (1998) 193 CLR 605, 630 [68].
[188] Mildren J in *Alcan 1 (*2007) 208 FLR 159, Martin CJ in *Alcan 2* [2008] 24 NTLR 33 and Barker P in *Origin Energy* (2007) 70 ATR 64.

also demonstrate that it has the capacity and will to attract *further* custom.[189] If a business did not have these features, while it may have a form of commercial goodwill which is recognised by accountants and business people, it is not the kind of goodwill which is recognised or protected by law.

To proponents of the narrow approach, the fact that a business may be highly profitable and worth significantly more than the market value of its underlying assets is irrelevant to the question of whether goodwill exists for legal purposes, and they tend to account for this excess value by re-allocating it to the business's identifiable assets. That this frequently results in values for those (primarily fixed) assets which are significantly higher than their market value is usually defended on the basis that it represents the ‘in use’ or ‘cash generating’ value of the assets,[190] even though it is unlikely that any purchaser would pay such an amount for those assets in the absence of the other assets and attributes of the business necessary to generate the cash flow. Such other assets and attributes rarely pass with a sale of any particular asset of the business, including the asset to which their value has been attributed, and in most cases, pass only with a sale of the business itself.

While proponents of the narrow approach agree that goodwill as property is ‘the 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 does not necessarily follow that one acquires goodwill when one acquires that right or privilege.[191] At least one judge sought to explain this obvious departure from *Murry* by pondering whether there might be another form of property inherent in a business which is distinct and separate from goodwill, the latter being confined to patronage.[192]

In this thesis, an approach which views goodwill exclusively as ‘the attractive force which brings in custom’ and focuses only on a business’s customer-attracting attributes is referred to as the ‘patronage’ approach. It is the approach taken by both of the Commissioners, and accepted by Mildren J in *Alcan 1*, to a greater and lesser extent by Chief Justice Martin and Justice Southwood in *Alcan 2*, and by President Barker in *Origin Energy*.

C. The ‘added value’ approach to goodwill

Proponents of a broader approach to goodwill reject the patronage approach and point to the *Murry* majority’s statements that ‘the courts have rejected patronage as the touchstone of goodwill in favour of the added value concept’[193] such that its existence now ‘depends upon proof that the business generates and is likely to continue to generate earnings from the use of the identifiable

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189 President Barker in *Origin Energy* (2007) 70 ATR 64, 104 [294]. Presumably his Honour was referring to the sources identified by the *Murry* majority at 611 [12], 615-16 [24]-[25].

190 See for example, Wayne Lonergan, ‘The valuation of in-situ plant and machinery’ (2009) 4 *Finsia Journal of Applied Finance* 31-35.

191 *Contra Murry* (1998) 193 CLR 605, 623 [45].

192 Southwood J in *Alcan 2* [2008] 24 NTLR 33, 73 [133].

193 Angel J in *Alcan 2* [2008] 24 NTLR 33, 69 [114] quoting *Murry* (1998) 193 CLR 605, 614 [20].

assets, locations, people, efficiencies, systems, processes and techniques of the business'.[194] They rely on the majority's definition of goodwill as property 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', and 'the valuable right or privilege to use the other assets of the business as a business to produce income', so that it necessarily follows that a person acquires goodwill when he or she acquires that right or privilege.[195] They say that a business which is operating and generating revenue is self-evidently attracting custom and that these are the only essential requirements for legal goodwill to exist.[196] All other factors may affect the value of that goodwill or indicate from where it is sourced from time to time, but they cannot determine its existence.

Those who take a broad approach to goodwill do not confine its sources to those which add value by directly attracting customers to deal with the business, but extend them to the many other value-adding attributes of a business, some of which may have no individual attraction for customers, but when combined with the other assets and attributes of the business, allow the business to be conducted in such a way that earnings are generated and value is added. Examples of these include:

(a) the benefit of having its assets assembled and in place and generating income;

(b) the efficient use of those assets;

(c) good and experienced management;

(d) a trained and assembled workforce;

(e) extensive market penetration;

(f) established and proven manufacturing and distribution techniques;

(g) established supply chains;

(h) a proven record of profitability;

(i) efficient work practices;

(j) low operating costs;

(k) knowhow;

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194 *Murry* (1998) 193 CLR 605, 611 [12]. See above n 77 in relation to the sense in which 'earnings' is used.

195 Ibid 615 [23], 623 [45]. *Alcan 2* [2008] 24 NTLR 33, 69 [114] (Angel J).

196 *Murry* (1998) 193 CLR 605, 611 [12]. Goodwill would also be present in a business which may not be presently trading and generating income but which is operational and capable of generating income such as a business which might have closed temporarily for renovations or other reasons.

(l) the absence of a construction risk;

(m) a good safety record; and

(n) good industrial relations with employees and unions.[197]

It follows that such attributes are of significant value to the business as without at least some of them, the business may struggle to attract customers of any number or variety, or perhaps be unable to operate at all. At the very least, their absence would negatively impact customers, affect cash flow and reduce the business's profitability. To take just one example, the level of skill and effort exhibited by the management and workforce of a business may impact business owner and customer alike and have material consequences for the value of the enterprise as a whole. This is because a quality skill set allows the economic potential of a business to be more fully utilised; and also because the presence of an *in situ* management team and workforce means that the potentially significant costs associated with hiring and training a replacement management team and workforce, and the consequential delays in production, are avoided. This would still be true even if a management team and workforce could be hired in the open market as the economic position of an acquiring entity faced with the prospect of having to undertake that task could not be viewed as equivalent to that of an acquirer of a business with an established, *in situ* management team and workforce. The existence of the *in situ* skilled team and workforce, and the right to continue to utilise them to produce income without interruption, must therefore be of value to both the business owner who continues to receive income, and customer who continues to receive a desired product or service, even in situations where replacements could in theory be hired.

Under a broad approach to goodwill, these and other positive advantages and attributes of an operating business are sources of goodwill for legal purposes because they work together with the other assets and attributes of the business to draw custom, generate revenue, save costs or add value in some other way.

For all of these reasons, an operating business will have goodwill for legal purposes regardless of the identity, quantity or nature of its customers, and whether or not it has the capacity or desire to attract further customers. Even if the business is unprofitable and worth no more than its break-up value, providing it is operating and generating revenue and is likely to continue to do so, it will still have goodwill for legal purposes, even if that goodwill is only of nominal value. On the other hand, if an operating business is worth more than the value of its underlying assets, that excess value is likely to be a reliable indicator of both the existence and value of its goodwill for legal purposes.

In this thesis, a broad approach to goodwill which treats goodwill as a bundle of rights and privileges and focuses on its 'value-adding' attributes is referred to as the 'added value' approach.

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[197] Some of these were identified by the majority in *Murry* although they were never intended to be exhaustive. See Ibid 611 [12], 615-617 [24] – [28].

To a lesser or great extent an added value approach to goodwill was taken by the taxpayers in *Alcan* and *Origin Energy*, by Justice Angel in the Northern Territory Court of Appeal, and in some respects, Justice Southwood in that same court. It is also the approach taken by the majority in *Murry*.

VI. ALCAN IN THE NORTHERN TERRITORY SUPREME COURT

A. Background

Alcan 1 was heard by Justice Mildren in the Supreme Court of the Northern Territory. The facts of the case are that in 2001, Alcan acquired 70% of the shares in Gove Aluminium Limited ('GAL**'**) from CSR Investments Pty Ltd ('CSRI**'**) while GAL bought back the remaining 30% of its share capital from AMP, as a result of which GAL became a company wholly owned by Alcan. The total acquisition price of the shares amounted to $A740.1 million. At the time of the acquisition, GAL held a 30% interest in the Gove Joint Venture bauxite and alumina business along with Swiss Aluminium Australia Pty Ltd which held 70%. As GAL's interest in the Gove Joint Venture business was its only asset, the price paid by Alcan for the shares was effectively paid for of a 30% interest in the bauxite and alumina business.[198]

The Commissioner of Territory Revenue considered that the transactions attracted the operation of Division 8A of Part III of the *Taxation (Administration) Act 1994* (NT) and the *Stamp Duty Act 1978* (NT) and assessed stamp duty on the transactions, including penalty, at $47,517,997.00. The basis for the assessment was the Commissioner's view that 60% or more of the value of GAL's total property (being the acquisition price of the shares with some minor adjustments) was comprised of 'land' in the form of mineral leases, options to renew those leases, and fixed plant and equipment. Alcan's objection to the Commissioner's assessment was disallowed and Alcan appealed to the Supreme Court to have the assessment set aside.

B. The arguments

Alcan argued that for the purpose of determining whether GAL had been entitled to land in the Territory, its interest in a special mineral lease and a series of special purpose leases should have been disregarded as they did not meet the statutory definition of 'land'. In the alternative, it argued that even supposing the land had included the options to renew the various leases, any valuation of these leases for the purpose of assessing stamp duty must have been affected by the fact that it had no right to renew special purpose lease 403, a lease providing for the deposit of waste products which was critical to the mining operations. The company further argued that notwithstanding there were statutory rights of renewal in respect of each of the other special purpose leases, those rights

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[198] In the reasons of the various judges in *Alcan 1* and *Alcan 2*, GAL's business is for the most part treated as synonymous with that of the Gove Joint Venture business operated by GAL and Swiss Aluminium Australia Pty Ltd. Where the judges draw a distinction, that distinction is also drawn in this thesis.

were merely personal and did not constitute land in the broader sense. Finally, Alcan sought to challenge the Commissioner's calculation of the land-rich ratio of land upon which stamp duty had been assessed contending that even if it failed in its previous arguments, the 60% threshold was not met because the Gove business had substantial non-land property in the form of goodwill.

In relation to the latter, Alcan referred the judge to the decision of the Court of Appeal of Victoria in *Uniqema 2* claiming that it supported a conclusion that the Gove business had goodwill in a legal sense and that the Commissioner had failed to take this into account. Alternatively, Alcan argued that even if the business had no goodwill in a legal sense, the Commissioner's assessment had failed to take account of its unidentifiable intangible assets (referred to by the Commissioner's expert Mr Lonergan as 'unallocated residual assets') which even if they were not legal goodwill in the sense of 'a tendency to attract customers', or property in their own right, were goodwill in the accounting sense. In any event the assets should not be treated as land.

Leaving aside the grounds unrelated to goodwill, the Commissioner submitted that there was a difference between the legal notion of goodwill and goodwill as accountants see it. While the latter define goodwill as 'the excess of the cost of acquisition incurred by (a purchaser) over the fair value of the identifiable net assets acquired' the legal notion of goodwill was summed up by Lord MacNaughten in *Muller* as 'the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in custom'.[199] The Commissioner argued that in *Murry*, the majority had said that it may be the site, personality, service, price or habit that obtains custom,[200] but in the present case, none of these features of the taxpayer's alumina business drew custom to the business as almost all the alumina produced at Gove was sold to its joint venturers' holding companies. However, even if this was not the case and the alumina was available in the market, the particular items or features of the Gove business which Alcan asserted were sources of goodwill did not entice customers to deal with the business in the sense required by *Murry*.

The Commissioner relied on the evidence of its expert witness Mr Lonergan, that Gove's refined product, alumina, was basically indistinguishable for practical purposes from the alumina product of the same grade of other producers so that there was no reason for any customer to stay loyal to the Gove joint venturers.[201] For these reasons, the Gove joint venture business could not be said to have 'an attractive force which brings in custom' and so it had no goodwill for legal purposes. In relation to the unidentifiable intangible assets being property in their own right or alternatively sources of accounting goodwill, the Commissioner contended that they were neither but were simply part of the 'in use' or *'in situ'* value of the business's fixed assets, all of which were to be treated as land. However, even if he was wrong and the Gove business had accounting goodwill,

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199 [1901] AC 217, 223-224.
200 *Murry* (1998) 193 CLR 605, 630 [68].
201 *Alcan 1* (2007) 208 FLR 159, 185-186 [106].

the Commissioner argued that this does not qualify as goodwill for legal purposes and is not property for the purposes of the land rich test.

C. The findings

Justice Mildren agreed with the Commissioner. Drawing heavily upon the passage in *Murry* that 'the attraction of custom still remains central to the legal concept of goodwill',[202] he found that even though at the relevant time GAL operated a very successful business which generated significant profits, the business had no 'attractive force which brings in custom and adds to the value of the business' and so no goodwill in a legal sense.[203] He also accepted the Commissioner's submission that GAL had no entitlement to goodwill in an accounting sense, but that even if it had such an entitlement, neither accounting goodwill, nor the items or features of the Gove business said to give rise to it, were property.[204]

In summary, his Honour made the following findings:

(a) Goodwill in a legal sense is 'the attractive force which brings in custom and adds to the value of the business';[205]

(b) To have goodwill in the legal sense of a tendency to attract customers:

   (i) a business must deal with a range of unrelated customers;[206]

   (ii) there must be evidence that the features or attributes of the business claimed to be sources of goodwill attract custom to the business;[207] and

   (iii) the business must not sell a homogenous or commodity product;[208]

(c) Accounting goodwill in the sense of 'excess value' is not goodwill for legal purposes;[209]

(d) Unidentifiable intangible assets or sources of accounting goodwill are neither assets nor property but are part of the 'in use' value of the business's tangible assets;[210] and

(e) The absence of an entry for goodwill on a balance sheet is evidence that a business has no accounting goodwill.[211]

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202 *Murry* (1998) 193 CLR 605, 614 [20].

203 *Alcan 1* (2007) 208 FLR 159, 185-186 [106]-[107].

204 Ibid 187 [113]-114], 189 [121]. While Justice Mildren does not acknowledge it, if GAL did have accounting goodwill which was not property, its value should have been deducted from the value of GAL's total property thereby reducing the value of its 'land' which had been calculated as a residual.

205 Ibid 185 [102]-[103].

206 In the case of GAL, it received 30% of the alumina produced by the joint venture and sold almost all of it to Gove Aluminium Finance Ltd although there were some small sales on the spot market and some swapping to supply the Tomago alumina smelter. In the 1998 and 1999 Annual Reports, it was stated that GAL 'has most of its alumina committed this year under long-term contracts'.

207 *Alcan 1* (2007) 208 FLR 159, 186 [107]-[108].

208 Ibid 185-86 [106].

209 Ibid 186 [108].

210 Ibid 189 [119]-[120].

D. The analysis

Each of his Honour's findings will be considered separately.

1. Goodwill in a legal sense is 'the attractive force which brings in custom and adds to the value of the business'

In Justice Mildren's view, *Murry* held that for goodwill to exist in a legal sense, a business must possess 'an attractive force which brings in custom and adds to the value of the business'. To demonstrate that it has such a force, a business must identify its sources of goodwill and show how they attract custom to the business. It is immaterial whether or not this results in the business having a value over and above the value of its identifiable assets. In this way Mildren J distinguished between goodwill in a legal sense and goodwill in an accounting sense which he said does not require the attraction of custom at all and exists merely if excess value is present.[212] In the case of the Gove joint venture business, his Honour found no evidence of the requisite 'attractive force' and so determined that the business had no goodwill for legal purposes.[213] This finding will be discussed in some detail shortly.

As a matter of principle, if the attraction of custom is *central* to the legal concept of goodwill, it must necessarily be *essential* to it. This is because unless a business can secure buyers for its products or services it will not be able to generate revenue and will eventually cease to operate. In this sense, the attraction of custom is both central and essential to the legal concept of goodwill. It therefore follows that any business which is operating and generating revenue through the sale or exchange of goods or services to customers can properly be said to possess the requisite attractive force. The *Murry* majority said as much when they pointed out that whether or not goodwill exists depends upon proof that the business generates and is likely to continue to generate earnings from the use of the identifiable assets, locations, people, efficiencies, systems, processes and techniques of the business.[214]

It is also important to note that the observation by the majority in *Murry* about the centrality of custom was made in the context of the judges pointing out that even if the enterprise value of a business is no greater than its break-up value, i.e. when there is no 'excess value' or so called 'accounting goodwill', the business may still have goodwill for legal purposes. This is because once goodwill is recognised as property in the form of the legal right or privilege to conduct the business in a certain way, the law will protect that right, for example, by restraining a vendor from soliciting

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211 Ibid 186 [106].
212 Ibid 185 [105].
213 Ibid 185-186 [106]-[107].
214 *Murry* (1998) 193 CLR 605, 611 [12]. See above n 77 in relation to the sense in which the majority use the term 'earnings'.

the customers of his or her old business. In this sense too, the attraction of custom can be said to remain central to the legal concept of goodwill.[215]

For these reasons, their Honours in *Murry* considered that the accounting or business concept of goodwill which emphasised the necessity for a business to have some value over and above the economic value of its identifiable assets was too narrow to accommodate the broader rights-based legal concept which encompassed not only the customer-attracting attributes of a business, but 'everything that adds value to the business – every possible advantage'.[216]

In *Alcan 1*, Mildren J interpreted the majority's observation about the centrality of custom to mean that unless an asset or attribute of a business directly attracts custom to the business, it cannot be a source of goodwill in a legal sense. There are several difficulties with this approach.

The first is that it ignores the fact that 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.[217] This is why goodwill is sometimes described as 'a quality or attribute that derives inter alia from using or applying other assets of the business'.[218] What follows is that an asset or attribute of a business may draw custom in one or more ways. It may do so of itself if customers are drawn to the business on account of the particular asset or attribute. Examples of such assets or attributes may be the location of the business or the identity or personality of the proprietor. It may draw custom through its use in combination with the other assets and attributes of the business. For example a business may draw custom because it has a convenient location *and* low prices. A customer may not be drawn if only one of these attributes exists, such as low prices, because the business is too far away. Similarly, a customer may not be drawn to the business, notwithstanding its convenience, because its prices are too high. But they will be drawn if both attributes exist. A third way an asset or attribute of a business may draw custom is by assisting to create advantageous circumstances or business conditions within which the business operates. For example a customer may be drawn to the business because it is a reliable supplier of a particular product or service. However, the business may only able to reliably supply the product or service because it has an efficient plant configuration, low operating costs, a highly trained workforce and harmonious industrial relations with its employees. On Justice Mildren's interpretation of *Murry*, none of the latter attributes would be sources of goodwill because they do not of themselves attract customers to deal with the business.

The second difficulty with Justice Mildren's approach is that it assumes that simply by dealing with the business, a customer necessarily adds value to it. This is not always true. For example, if a particular customer is slow at paying its accounts or fails to pay them at all, or if it is difficult and

215 Ibid 614 [20].
216 Ibid 624-25 [50].
217 Ibid 615 [24].
218 Ibid.

takes up significant management time or resources, or if it demands deep discounts leaving little or no profit for the seller, its custom may add little or no value to the business at all.

A third difficulty is that it assumes that a customer's motivation for dealing with a business is transparent and can be readily traced to a particular asset or attribute of the business. This may be true in some instances, but in others, a customer may be motivated to deal with the business for reasons which are not easily discernible or which may be unconnected to any single asset or attribute of the business. An example of the latter may be an inability to deal with competitors perhaps because of a conflict of interest.

A further difficulty with Justice Mildren's approach, or with any approach which seeks to confine goodwill to patronage, is that it assumes that customer relationships are the only source of value in a business. This ignores the fact that value may be added to a business through means which have little or nothing to do with customer attraction. For example, value may be added through the ability of a business to reduce or effectively manage its costs. This may be achieved through many means, examples of which include the presence of a highly trained or efficient workforce, internal efficiencies and synergies, good relations with suppliers, the configuration of plant and equipment, harmonious industrial relations with unions and employees, a good safety record, and superior credit management ability.[219] Some of these attributes of a business may have an indirect effect on its customer relations while others may have no discernible effect at all. Some may have an effect in some businesses, but not in others. For example, the fact that the plant is cleverly configured may add value to the business because the plant is more efficient, is safer to operate, costs less to maintain and enjoys an extended life. This may have no effect on customer relations in some businesses, while in others it may have an indirect effect if it leads to reliability and continuity of supply or translates to lower prices. However, it may lead to neither or even if it does, may not influence customers either way if other factors such as poor product quality or unfavourable terms of payment weigh against it.

Similarly, harmonious industrial relations or a good safety record may add value to a business by attracting better staff or decreasing staff turnover. In some businesses, perhaps some retail businesses in particular, this may translate to lower prices or better service which in turn may attract customers to deal with the business. But in some businesses, it may not result in lower prices or better service at all but may simply allow the business to increase its profits, including by reducing

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[219] For further reading on the subject of sources of value in a business which are not necessarily customer-related, see Rita Almeida and Pedro Carneiro, 'The Return to Firm Investment in Human Capital' (Working Paper No 3851, World Bank Policy Research, 2006) <http://go.worldbank.org/XRIK7M6YJ0> at 12 October 2010; Margaret Blair and Stephen M H Wallman, *Unseen Wealth – Report of the Brookings Task Force on Intangibles,* (Brookings Institution Press, 2001); B Brinker, '*Intellectual Capital: Tomorrow's Asset, Today's Challenge'* CPA Vision Project <http://www.cpavision.org/vision/wpaper05b.cfm> at 21 June 2010; Roy Farthing, 'The Valuation of Specialised Operational Assets – Unbundling Enterprise and Asset value' (2010) 2 *JASSA* 35; Global Access Partners Pty Ltd, 'GAP Congress on Knowledge Capital 2005 Report' (Paper presented at the Gap Congress on Knowledge Capital, Melbourne, 3 and 4 November 2005); J Riley, 'Who Owns Human Capital? A Critical Appraisal of Legal Techniques for Capturing the Value of Work' (2005) 18 *Australian Journal of Labour Law* 1-25; and Robert Reilly and Robert P Schweihs, *Valuing Intangible Assets* (McGraw-Hill, 1998) 37.

its staff numbers. Does the first business have goodwill but the second not? Is the first business worth more than the second even though the second business may be more profitable? If not, to what is any excess value present in the second business attributable? As will be seen shortly, Justice Mildren answered the latter question by attributing the excess value in the Gove business to the business's fixed assets.

At its very heart, Justice Mildren's judgment demonstrates a fundamental misunderstanding of the majority decision in *Murry*. While it is true that the judges referred to numerous judicial and other descriptions of goodwill, including Lord Macnaghten's 'attractive force which brings in custom', they recognised that none of these descriptions were exhaustive and that many were the result of a particular focus on one or other of the aspects of goodwill. For this reason they said that it was important to understand the nature or purpose of the inquiry.[220] For example, when a court is asked by the owner of an unprofitable business to protect the goodwill of the business by restraining a previous owner from soliciting business from its customers, the *sources* of the business's goodwill are the focus. On the other hand, where a business has been destroyed through the malicious or negligent act of a third party, a court may be required to determine the *value* of the goodwill in order to award damages. In each case, goodwill may be described in such a way as to reflect the particular aspect which is under review.

In *Alcan 1*, the nature or purpose of the enquiry was to ascertain whether the value of GAL's land was worth 80% or more of the value of its total property. The relevance of goodwill to the enquiry was that if GAL was entitled to goodwill, the value of that goodwill contributed to the value of GAL's total property, but not to the value of its land. Depending upon their respective values, this could materially affect the outcome of the application of the land rich test. Therefore the purpose of the goodwill enquiry concerned the *existence*, *proprietary nature* and *value* of goodwill.

This should have prompted Justice Mildren to ask three questions. The first being 'was GAL's business operating and generating revenue and was it likely to continue to do so?'[221] If so, goodwill existed for legal purposes. The second question was 'did Alcan acquire the legal right or privilege to make use of all that constituted the attractive force of the Gove joint venture business to generate earnings and otherwise create value?'[222] If so, Alcan acquired the proprietary asset of goodwill upon its acquisition of GAL. The third question was 'how should the value of that goodwill be measured?' As the Gove business was profitable, the value of its goodwill could be ascertained by the usual accounting method of deducting the value of the business's identifiable assets from the value of the business enterprise.[223] If his Honour had asked the right questions, he would have concluded that

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220 *Murry* (1998) 193 CLR 605, 611 [12].
221 Ibid.
222 Ibid 615 [23] and 623 [45].
223 Ibid 624 [49].

the Gove business in which GAL had an interest had substantial property in the form of goodwill, the value of which was sufficient to prevent GAL from being found to be land rich.

Instead, having wrongly confined goodwill for legal purposes to the customer-attracting attributes of a business, Justice Mildren went on to consider what kind of customers must be attracted, and what kind of product or service the business must sell, in order for an attractive force which brings in custom to exist.

2. To have goodwill in the legal sense of a tendency to attract customers, a business must deal with a range of unrelated customers

In Justice Mildren's view, a business will not be able to evidence the requisite attractive force which brings in custom if it deals only with related customers, or a single customer, or if it commits all or most of its product under long term sales contracts. Applying this reasoning to the Gove joint venture business, his Honour acknowledged that the joint venturers operated a very successful business which generated significant profits. However, as GAL sold almost all of its alumina to related companies under long term contracts with only small amounts either sold on the spot market or swapped with another refinery, its business had no attractive force which drew custom to the business and so no goodwill for legal purposes.[224]

Given that any business which generates revenue through the sale or exchange of its product necessarily attracts custom of some kind, why does it matter whether this custom is that of related or unrelated buyers, or whether there are many buyers or only one? Of what possible relevance to the legal enquiry is it whether the product or service is sold under long term contracts or across the counter? On one view, the business which has managed to guarantee its custom through long term contracts might be seen to have more of an attractive force than that of a business with no such guarantee.

Consider the example of a profitable business which sells widgets to multiple unrelated customers. On any view, it may be expected to possess goodwill. The business makes a decision to sell all of its widgets to a single customer under a single supply agreement. Such an arrangement might be seen as beneficial in order to ensure a minimum volume of orders, reduce overheads and guarantee revenue. The customer may even acquire an interest in the business. In such a scenario the goodwill of the business has not vanished. Nor has it been subsumed into the value of the other assets of the business. The business continues to operate and generate revenue through the combined use of its assets and as such continues to have goodwill, although the sources of that goodwill may have changed. In these circumstances, the attractive force of the business has not ceased to exist, it is merely being utilised in a different manner.

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224 *Alcan 1* (2007) 208 FLR 159, 185-186 [106].

In *Alcan 1*, Mildren J did not consider that by operating and generating revenue from the sale of alumina, the Gove business was necessarily displaying its attractive force and evidencing the existence of goodwill for legal purposes. That the value of that goodwill was substantial was also evident in the significant margin between the market value of the business enterprise and the market value of its identifiable assets.

To interpret *Murry* as his Honour did is to take the High Court where it refused to go; back to an historical doctrine of goodwill which had patronage as its touchstone. When one considers the rapidly changing nature of modern commerce and the sophistication of modern business structures, a legal doctrine of goodwill founded on the patronage based 'corner store' business model of centuries past when sole proprietorships and partnerships were the business norm is unlikely to be of much utility.

Even as early as 1913, Esquerre observed how the rise of the corporate business structure had impacted upon the nature of the goodwill generated within a business:

> The nature of the goodwill of corporations appears to be quite different from that of the goodwill of sole proprietorships and of co-partnerships. When corporations sell their assets, it often happens that the identity of the vendor is lost in that of the vendee. In this case the purchaser does not expect that the customers of the vendor will resort to the old place. He acquires the earning power of an established business whose products will sell, no matter who offers them for sale. He may also, perhaps, figure that with more up-to-date methods of conducting the business through the application of scientific economy and the union of forces which, up to now, had been antagonistic, larger profits will be obtained than could be had before the consolidation of interests took place. For this he is willing to pay a sum of money which may be far in excess of the value of the tangible properties acquired.[225]

How much more in the 21st century, where business norms includes multinational, vertically integrated,[226] franchised and virtual businesses operated by public and private corporations, joint ventures, trusts and syndicates, and where the product or service sold may be wholly or partly intangible, should the law strive to remain relevant. On the added value approach, the business described by Esquerre would have goodwill for legal purposes. Compare this to Justice Mildren's patronage approach which would deny its existence and subsume its value into that of the 'tangible properties acquired'.

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225 Paul-Joseph Esquerre, 'Goodwill, Patents, Trade-Marks, Copyrights and Franchises'; in Maurice Moonitz and Ananias Charles Littleton (eds) *Significant Accounting Essays* (Prentice-Hall Inc, 1965) 481.

226 In vertically integrated businesses or groups of companies, only the downstream business or entity may participate in a competitive market and so attract customers of the variety contemplated by Mildren J, even though each of the upstream businesses contribute to the creation of the product or delivery of the service to those customers. In such circumstances the downstream business may be said to have goodwill on the patronage approach yet it would be misleading to attribute the entire goodwill of the vertically integrated business or group to the ultimate downstream business. This is demonstrated in the likely fact that a purchaser of the downstream business would only pay an amount for goodwill which reflected the goodwill of that business and not the goodwill of all of the businesses in the vertically integrated group.

If Justice Mildren's conclusion is correct and the goodwill of the Gove joint venture business is a legal nullity, it follows that Alcan would have no right to damages for injury to its business should it be adversely affected through the unlawful conduct of a third party. In *Murry*, the majority gave an example of the owner of a business whose building was destroyed by the conduct of a third party thereby also damaging its business. In those circumstances, the High Court said that the owner would have all the rights that inhere in the owner of a building that has been damaged by the conduct of a third person, and may also have a right to damages for the injury to the goodwill of the business.[227] That is, the owner would have rights both as owner of the tangible asset which had been destroyed i.e. the building, and as owner of the intangible asset that had been damaged i.e. the goodwill of the business, and that the two should not be confused. Yet on a patronage approach to goodwill, a right to damages for injury to the goodwill of the business would exist only if the business earned its income by selling a non-homogenous product to multiple, unrelated customers, but not otherwise.

The majority's example also exposes the error in the approach of allocating all of the excess value in a business to its tangible assets as Mildren J was persuaded to do in *Alcan 1*. This is because if the situation arose where the Gove plant was damaged or destroyed by the unlawful act of a third party, the joint venturers would not likely be compensated for injury to the plant, either by insurance or by an award of damages, in an amount equivalent to Mr Lonergan's 'in use' or 'cash generating' value of the plant[228] for the simple reason that the cash generated is that of the business *including* the plant, and not the plant alone. This aspect of his Honour's reasoning will be discussed in more detail shortly.

What is clear from this discussion of *Alcan 1* is that for Mildren J, patronage or custom is still the touchstone of goodwill and this belief shaped every aspect of his reasoning. Yet as the *Murry* majority observed, the courts have rejected this approach in favour of a broader added value approach to goodwill. To the extent that legal goodwill connotes an attractive force which brings in custom, that force may just as well be present in a vertically integrated mining or manufacturing business which deals with a single related customer as it is in a sole proprietorship retail business which deals with multiple unrelated customers. What is important is that the business is operating and generating revenue and expects this to continue.[229]

3. To have goodwill in a legal sense, there must be evidence that the features or attributes of the business claimed to be sources of goodwill actually attract custom to the business

In *Alcan 1*, his Honour was persuaded that even if the features or attributes claimed by Alcan to add value to the Gove business did exist, they were not goodwill or sources of goodwill in the legal

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227 *Murry* [1998] 193 CLR 605,618 [30].
228 Calculated on a discounted cash flow basis.
229 Ibid 611 [12].

sense because they did not directly attract custom, and it necessarily followed that they were not, as an homogenous group severed from their sources, property which was capable of separate valuation.[230]

The features or attributes referred to were: avoidance of a construction period; expansion and optimisation possibilities; methods of operating and know-how that permitted the business to operate; and the possibilities of further cash flows after the bauxite reserves were exhausted. Mildren J found that these features or attributes of the Gove business could not produce goodwill in a legal sense because despite the business being highly profitable (through one would have thought the self-evident attraction and maintenance of substantial custom) he could find no evidence of customers being attracted to the business on account of those particular features or attributes.

With respect to his Honour, his reasoning is erroneous. Nowhere in the *Murry* judgment or in any other authority which was cited to Justice Mildren was there a requirement that for a business to have goodwill in a legal sense, there must be evidence of particular customers being attracted to the business on account of one or more of its identified attributes - even less the specific kind of customer required by his Honour. Rather, what the majority said must be proved is that the business generates and is likely to continue to generate earnings from the use of its identifiable assets, locations, people, efficiencies, systems, processes and techniques.[231]

But even if such a causal connection is necessary, it is arguable that customers were attracted to transact with the Gove business on account of its various features and attributes, including those identified by Alcan. Those customers were primarily, although not solely, the joint venturers' related companies. Whether related or not, a buyer will only purchase a product or service from a seller if there are greater advantages or benefits in doing so than in producing the product or providing the service itself, or acquiring it elsewhere. The advantages or benefits GAL's related companies may have enjoyed by purchasing alumina from GAL rather than producing the product itself or acquiring it from another producer would include those identified by Alcan, as well as others such as synergies, economies of scale and other long term cost advantages, tax benefits, quality control and a reduction in market risk. That such advantages or benefits may have existed and were at least partly the reason for Alcan's acquisition of GAL was acknowledged by Mildren J although he does not set them out in detail in his judgment on account of their commercial sensitivity.[232] On this basis, even on his Honour's narrow patronage approach to goodwill, the Gove business could be said to possess an attractive force which brings in custom and adds value to the business.

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230 *Alcan 1* (2007) 208 FLR 159, 187 [114].
231 *Murry* (1998) 193 CLR 605, 611 [12]. See above n 77.
232 *Alcan 1* (2007) 208 FLR 159, 186 [107].

In relation to Alcan's reliance on *Uniqema 2*, his Honour found that the case had no application stating that while *Uniqema* involved the sale of a business which clearly had a component for goodwill in the legal sense of a tenancy to customers, the present case did not.[233] As has been discussed in Section III D 2 above, in *Uniqema 1,* the Commissioner argued that the value ascribed by the parties to goodwill should in fact have been ascribed to the land as the goodwill of the business was derived from the land. The Victorian Court of Appeal dismissed the Commissioner's appeal saying that there was no evidence to support the Commissioner's contention that part or all of the value of the goodwill was attributable to the land, because the land provided no basis for attracting customers beyond that which any factory and any business enterprise would produce. Rather the business could have been successfully conducted at any location given that the products manufactured at the site were sold from the company's head office in Malaysia.

Alcan argued that this was also the case in respect of the Gove alumina refinery which it said could be located on any piece of land either in the vicinity of the mine, or elsewhere and did not need to be located on Special Mineral Lease 11. Unfortunately for Alcan, although Justice Mildren agreed that the Gove business had no site goodwill, he found that it had no goodwill at all because in his view, its assets or features did not attract arms-length customers to the business.

As has been previously stated at Section III D 5 of this thesis, the difficulty with Ormiston J's reasoning in *Uniqema 2* is that even if the land had been a source of goodwill, that goodwill did not inhere in or enhance any particular asset of a business and so its value cannot be incorporated into the value of that asset. It is true that an asset such as land may be worth more because it is an attractive site upon which to conduct a business, and because ownership of the land carries with it the ability to profit from the land either by conducting a business on it personally or by leasing to another for that purpose. The *Murry* court called this the 'potential use value' of the land, but said that this does not mean that one may incorporate the value of the goodwill of the business being conducted on the land into the value of the land itself as they are two separate items of property. Nevertheless, in *Alcan 1* although Justice Mildren found that the Gove business had no goodwill of any kind, the practical outcome was the same and the value of GAL's land was artificially inflated such that it almost equalled that of GAL's interest in the entire business enterprise.[234]

4. To have goodwill in a legal sense, the business must not sell a homogenous or commodity product

Justice Mildren accepted Mr Lonergan's evidence that the alumina produced by the Gove joint venturers, was basically indistinguishable for practical purposes from the alumina product of the same grade of other producers such that there was no reason for customers to stay loyal to the

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233 Ibid [109], [111].

234 This also occurred in *Morvic* [2002] ATC 4459 and *HSH Hotels* (2005) 58 ATR 276.

Gove joint venturers or any other alumina producer.[235] According to his Honour, this supported a conclusion that the business had no attractive force and therefore no goodwill for legal purposes.

Pushed to its logical conclusion, on this reasoning, few resource businesses will have goodwill for legal purposes. Yet there is nothing in *Murry* to support a proposition that a business selling a homogenous or commodity product lacks goodwill for the reason given by the Commissioner's expert or for any other reason. Many successful businesses deal in homogenous or commodity products. If such businesses generate revenue, then necessarily customers have been attracted to deal with the business. In the case of a homogenous resource product this might be for all sorts of reasons which are unrelated to the product itself. Some may be location related such as accessibility of the product to a railway or port, proximity to an end customer, low sovereign risk or the existence of a favourable government regulatory environment. Others may be service related such as reliability and consistency of supply, ability to supply volumes required, favourable take or pay terms or terms of payment generally, or readiness to replace defective products. Still others may be seller related such as the financial stability of the seller, its reputation, management or superior marketing initiatives. A related customer is just as likely to be drawn to deal with a business for these reasons as an unrelated customer, although the former may also be drawn for additional reasons such as the ability to obtain synergies or other efficiencies or to guarantee long term supply or cost advantages, or for quality control purposes. The suggestion that a business supplying a homogenous or commodity product must for that reason lack goodwill is simply wrong. Whether goodwill exists for legal purposes turns not on the nature of the product or service that the business sells, but on whether the business is operating and generating revenue and expects to continue to do so.

5. Accounting goodwill in the sense of excess value is not goodwill for legal purposes

Counsel for Alcan had submitted that even if the Gove business did not have legal goodwill in the sense of a tendency to attract customers, it had goodwill in the accounting sense of excess value and that the same principles apply to each. By this he meant that the same assets, features and attributes of the Gove business said to be sources of legal goodwill on a patronage approach, were also sources of accounting goodwill. This accounting goodwill, or the unidentifiable intangible assets which comprised it, was property separate from the land used to conduct the business.

The Commissioner's position was that no such assets, features or attributes existed which could give rise to accounting goodwill, but even if they did, they were part of the land and fixtures to which GAL was entitled and contributed to their value. They were not separate intangible assets and were not separate property.

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235 *Alcan 1* (2007) 208 FLR 159, 186 [106].

Before discussing his Honour's response to the parties' arguments, it is important to both explore what is meant by an ‘intangible asset’, and to differentiate between *identifiable* and *unidentifiable* intangible assets - the latter of which Alcan’s expert treated as synonymous with ‘accounting goodwill’.

There are numerous legal, accounting or taxation-related definitions of the terms ‘intangible asset’ or ‘intangible property’. Most of these definitions are purpose-specific. For example in section 136(1) of the *Fringe Benefits Tax Assessment* Act *1986* (Cth), ‘intangible property’ is defined to mean ‘real property’, ‘a chose in action’ and ‘any other kind of property other than tangible property’.[236]

Under each of Australian Accounting Standards, International Accounting Standards (‘IAS’) and the more recent International Financial Reporting Standards (‘IFRS’), intangible assets are defined as ‘non-monetary assets without physical substance’. [237] To be recognised on the balance sheet, they must be identifiable, controllable, able to be reliably measured, and produce future economic benefits such as revenue. To be identifiable, an intangible asset must be separable from the business and capable of being transacted, or it must arise from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.[238]

Meanwhile, the authors of the influential 2001 Brookings Report entitled *Unseen Wealth – Report of the Brookings Task Force on Intangibles*[239] define intangible assets less prescriptively as:

> … non-physical factors that contribute to, or are used in, the production of goods or the provision of services or that are expected to generate future productive benefits to the individuals or firms that control their use.[240]

On this definition any factor which contributes to productive capacity may potentially qualify as an intangible asset and so is a much broader concept than intellectual property in the form of patents, copyrights, trade secrets, trademarks or other assets which receive legal protection.

In their leading text on the subject of intangible assets and goodwill, *Valuing Intangible Assets*,[241] Robert Reilly and Robert Schweihs claim that most businesses own intangible assets. They point to the fact that the S & P 500 price index is several times the tangible asset book value of the companies included in the index and say that even after adjustments for understated tangible asset

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[236] The definition goes on to exclude a right arising under a contract of insurance or a lease or licence in respect of real property or tangible property.

[237] AASB 3 *Business Combinations*, *AASB 138 Intangible Assets, IFRS 3(R) Business Combinations* and *IAS 38 Intangible Assets.* An intangible asset is similarly defined in IPSAS 31 *Intangible Assets* issued by the International Public Sector Accounting Standards Board in January 2010.

[238] For example, See Appendix A in AASB 3 *Business Combinations*.

[239] Blair and Wallman, above n 219.

[240] Ibid 10.

[241] Reilly and Schweihs, above n 219.

values and other factors (such as capital cost recovery for example), the fact remains that intangible asset value exists on a widespread basis in all sizes of business across corporate America.[242]

The same can be said of corporate Australia according to a report by Synergies Economic Solutions dated September 2004 and entitled 'Intangible Assets in the Central Queensland Coal System – A report to Network Access' (the 'Synergies Report'). The report was prepared for Queensland Rail in respect of Queensland Rail Network Access in support of Queensland Rail's 2005 draft access undertaking submitted to the Queensland Competition Authority. Queensland Rail Network Access is the regulated monopoly rail service provider which operates the rail network for Queensland Rail.

The Synergies Report contains a ratio of market valuations to net assets for the top 25 Australian listed companies for the period 1990 – 2003 (excluding banks and property trusts). It shows that the ratios of market to accounting values over this period were between 1.5 and 2, despite the fact that these entities operate in highly competitive domestic and international markets.[243] This lead the authors to conclude that '[c]learly … intangible assets have assumed enormous economic significance in the Australian economy and this is reflected in the level of corporate valuations'.[244]

Dr Nigel Finch of the Faculty of Economics and Business at the University of Sydney has a similar view. In a 2006 article in which he examines the disclosure of intangible assets by 'high user' industrial firms in the Australian market subsequent to the introduction in 2005 of specific Australian and International accounting standards for intangible assets, he states:

> For an increasing proportion of businesses the principal assets they own and employ in business are 'intangible' in their character. They tend to be are long-lived assets, and despite their lack of physical presence, they represent the 'infrastructure' on which, and by which, such businesses earn their future cash flows and profits. One meaning of intangible is 'not cognizable by the sense of touch' and this implies that they cannot be touched, but the meaning implied by accountants is more realistically interpreted as 'difficult to value' (Tiffin, 2005 p. 66).[245]

The accounting standards Finch refers to are AASB 138 *Intangible Assets* ('AASB 138') and IAS 38 *Intangible Assets* ('IAS 38'), the former of which was issued by the Australian Accounting Standards Board ('AASB') and came into effect on 1 January 2005. As its name implies, AASB 138 is based on IAS 38 which was issued by the International Accounting Standards Board ('IASB') in 1998.

AASB 138 deals with the definition, recognition and disclosure of intangible assets and requires financial statements to disclose for each distinct class of intangible asset, among other things:

(a) the useful life, amortisation rate and method; and

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242 Ibid 37.
243 Synergies Economic Solutions, 'Intangible Assets in the Central Queensland Coal System – A report to Network Access' (2004) 22.
244 Ibid.
245 Finch, Nigel, 'Intangible Assets and Creative Impairment - An Analysis of Current Disclosure Practices by Large Australian Listed Firms' (2006) 5(2) *Journal of Law and Financial Management* 18.

(b) the gross carrying amount and accumulated amortisation at the beginning and end of the period.[246]

According to AASB 138, entities frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights.[247]

However, not all of these resources meet the definition of an intangible asset in terms of identifiability, control over a resource and existence of future economic benefits. If an item within the scope of AASB 138 does not satisfy these criteria, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date.[248]

The definition of an intangible asset in AASB 138 requires that the asset be identifiable in order to distinguish it from goodwill. Goodwill acquired in a business combination represents a payment made by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised. The future economic benefits may result from synergies between the identifiable assets acquired or from assets that, individually, do not qualify for recognition in the financial statements but for which the acquirer is prepared to make a payment in the business combination.[249]

According to AASB 138, an asset meets the identifiability criterion of an intangible asset when it:

(a) is separable, that is, is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or

(b) arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.[250]

AASB 138 also contains detailed information relating to accounting recognition criteria for an intangible asset stating that an intangible asset shall be recognised only if 'it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity…'.[251]

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246 AASB 138 (2009) [118].
247 See AASB 138 (2009) [9].
248 Ibid [10].
249 Ibid [11].
250 Ibid [12].
251 Ibid 18 [21]-[23].

Although the Standard does not use the term ‘unidentifiable intangible asset’, valuers and accountants often use the term to describe the intangible features and attributes of a business which have value, but which do not meet the identifiability or other criterion of an intangible asset. The value of such features and attributes is treated as representing the value of the goodwill of the business.

Reilly and Schweihs list some of these ‘unidentifiable intangible assets’ or ‘economic phenomena’ that contribute to the value of the goodwill of a business. They include:

(a) market share;

(b) high profitability;

(c) lack of regulation;

(d) a regulated or protected position

(e) monopoly position or barriers to entry;

(f) market potential;

(g) breadth of appeal;

(h) mystique;

(i) heritage of longevity;

(j) competitive edge;

(k) life-cycle issues;

(l) uniqueness;

(m) discount prices;

(n) liquidity or illiquidity; and

(o) ownership control or lack of control.[252]

In Reilly and Schweihs' view, the intangible assets of a business contribute to the economic income of the business as much as its buildings and machinery. They argue that it is the underlying intangible asset value in a business, and the coordination of those assets, that fuels growth.[253]

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252 Reilly and Schweihs, above n 219, 8.
253 Ibid 37-38.

Returning to *Alcan 1*, Mildren J stated that before dealing with the differences between the parties' experts, it was necessary that he first deal with whether or not as a matter of law, there can be value to unidentifiable intangible assets other than goodwill and what is meant by the notion of goodwill.[254] He commenced by referring to the discussion in *Murry* where the majority explained that while goodwill is property, many of the sources of goodwill are neither property nor assets in an accounting sense. He said the majority's examples included the efficient use of the assets of the business, superior management practices and good industrial relations, the result of expenditure on advertising and promotions or on labour relations and customer services.[255]

However, his Honour said that even if he were to accept the approach of Alcan's expert to unidentifiable intangible assets such that the Gove business could be said to have 'accounting goodwill', this was different to goodwill in the legal sense of a tendency to attract customers. Only the latter was property and an asset in its own right.

> What is very clear from that judgment is that the 'attraction of custom still remains central to the legal concept of goodwill' (*Murry* (supra) at 614 [20]) whereas, from an accounting point of view, it is not necessarily related to the attraction of custom at all.[256]
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> …
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> There is simply no evidence, or insufficient evidence, to conclude that GAL had any goodwill in that sense in 2001. There is an assertion by the appellant that there is no difference between the value of goodwill for accounting and legal purposes, relying on a passage in *Federal Commissioner of Taxation v Murry* (above) at 624, but in my opinion that passage does not support this contention. The Court there said that 'in a profitable business, the value of goodwill for legal and accounting purposes will often, perhaps usually, be identical', but that does not mean that their Honours intended to depart in any way from the point that it is the attraction of custom which is fundamental to that concept.[257]

His Honour said that it follows from this discussion that even if he were to accept the validity of Mr Bryant's approach to the identification of unidentifiable intangible assets, 'they are not goodwill in the legal sense and it necessarily follows that they are not, as an homogenous group severed from their sources, property and are incapable of separate valuation.'[258]

What Justice Mildren means is that even though a business may have features or attributes which clearly add value to it, unless those features or attributes attract (a certain kind of) custom to the business, the business may have 'accounting goodwill' but it will not have 'legal goodwill'. Only legal goodwill is property. Neither accounting goodwill, nor the features or attributes of the business

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254 *Alcan 1*(2007) 208 FLR 159, 185 [101].
255 *Murry* (1998) 193 CLR 605, 616 [27].
256 *Alcan 1* (2007) 208 FLR 159, 185 [105].
257 Ibid 186 [108].
258 Ibid 187 [114].

which give rise to it are property. This is true he said whether the features or attributes are viewed separately or as a whole.

Mildren J's analysis, which was at least in part prompted by the manner in which the matter was argued before him, demonstrates a confusion about the relationship between goodwill for legal purposes, and goodwill as recognised and measured by accountants. For accountants, goodwill exists if excess value exists and does not exist in the absence of that value.[259] In this way the existence and value of goodwill are not just related, they are fused. However while the *Murry* majority pointed out that in a profitable business, the *value* of goodwill for both legal purposes and accounting purposes will usually be identical,[260] it is not essential that this excess value be present in order for goodwill to *exist* in a legal sense. It is for this reason that an unprofitable, but going business can have goodwill in a legal sense, even if its value is difficult to assess.[261] This is because on its proper legal construction, goodwill is the valuable right or privilege to make use of all that constitutes the attractive force of a business to generate earnings or add value. Such goodwill exists, whether it results in excess value or not. Alcan acquired this legal right or privilege when it acquired the shares in GAL and as a consequence, also acquired property in the form of goodwill.[262] As the Gove business was profitable, the traditional accounting method of measuring goodwill as excess value was appropriate.

What should be clear from the *Murry* majority's discussion is that although accountants do not distinguish between the *existence* and the *value* of goodwill and will only recognise the former in the presence of the latter, the law does make a distinction and will recognise the existence of goodwill even if it is of little or no value. As such, the legal concept of goodwill is a wider concept than that known to accountants and is present in any operating business which is generating revenue and is likely to continue to do so. For this reason, goodwill can exist for legal purposes even if it does not exist for accounting purposes. Mildren J's patronage approach to goodwill, and his failure to understand the relationship and differences between goodwill in an accounting sense and goodwill in a legal sense, required him to necessarily search for a repository for the excess value which was clearly present in the Gove joint venture business. The alternative was to accept that Alcan had paid close to half a billion dollars (or between 48% and 55% of the purchase price of the shares) for something that, in his Honour's view, was 'not an asset and was unidentifiable, unrealisable and intangible'.[263]

Guided by the Commissioner's expert, Mildren J fell into the additional error of pushing the excess value attributable to the goodwill of the business into the value of its underlying assets – despite

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[259] The approach of accountants is to recognise goodwill only on acquisition or sale and not to recognise internally generated goodwill on account that it cannot be reliably measured, See AASB 138 (2009) [48].

[260] *Murry* (1998) 193 CLR 605, 624 [49].

[261] Ibid 625 [50]. See also *Pathirana v Pathirana* [1967] 1 AC 233; [1966] 3 WLR 666: Goodwill may exist even though it cannot be valued in monetary terms.

[262] *Murry* (1998) 193 CLR 605, 623 [45].

[263] Ibid 185 [101].

those assets having already been the subject of a proper valuation which was otherwise not in dispute, including by Mr Lonergan. To grossly inflate the value of those assets in this way is contrary to GAVP and is at variance with the International Valuation Standards developed by the Standards Board of the International Valuation Standards Council ('IVSC') and adopted by both the Australian Property Institute ('API') and the New Zealand Property Institute ('NZPI').[264] It is also at odds with Mr Lonergan's own published works.[265]

6. Unidentifiable intangible assets or sources of accounting goodwill are neither assets nor property but are part of the 'in use' value of the business's tangible assets

The Commissioner contended that even if accounting goodwill was property, which he denied, Alcan had no accounting goodwill because the Gove business was worth only marginally more than the value of its identifiable assets, those assets being primarily land in form of interests in land, fixed plant and equipment.[266] To demonstrate this, the Commissioner's expert used a top down residual method ('TDRM') to value the land.[267] This involved treating the price paid for the shares (with some minor adjustments for tax) as representing the value of GAL's total property, deducting some minor amounts for excluded assets[268] and chattels, and concluding that the remainder was land. The residual land value was then used as the numerator and the price paid for the shares (less the minor adjustment for tax and deductions for excluded assets) the denominator in the land rich equation. Not surprisingly, on this analysis, GAL was more than 90% land rich.[269]

Counsel for Alcan submitted that Mr Lonergan's valuation was faulty and was bound to conclude that the business had no value over and above that of its identifiable assets because his TDRM required him to first assume that there were no unidentifiable intangible assets or goodwill to be accounted for. While the reasons for the submission are not spelt out in the judgment, they are obvious. If unidentifiable intangible assets or goodwill in an accounting sense is measured as the excess value over and above the value of the identifiable assets of the business, it is by nature measured as a residual. However, in the TDRM, land is the residual. For this reason, the TDRM can only ever be used to value land if one has already concluded that there is no goodwill or unidentifiable intangible assets to be measured. This allows one to then simply deduct the value of

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264 IVSC, *International Valuation Guidance Note 3*, *Valuation of Plant and Equipment*, AUSNZ [5.1.4]. Note that Guidance Note 3 has since been updated and carried forward to IVS 220 *Plant and Equipmen*t in the IVSC's new 2011 international valuation standards which became effective on 1 January 2012.

265 See for example Wayne Lonergan, *The Valuation of Mining Assets* (Sydney University Press, Sydney, 2006) 142 where Mr Lonergan states that plant should be valued at its DORC or its DCF value *if this is lower*. Note however Mr Lonergan's recent article 'The valuation of in-situ plan and machinery', (2009) 4 *The Finsia Journal of Applied Finance* 31-35 in which he deviates from this approach arguing that in-situ fixed assets may be worth a lot more than their depreciated historical cost, DRC or depreciated indexed replacement cost.

266 Note that the fixed assets are treated by Mr Lonergan as being one and the same as 'land' in terms of their cash generating capacity, value and identification.

267 A TDRM such as that used by Mr Lonergan was also used by the Commissioners' experts in *EIE Ocean* [1998] 1 Qd R 36 and in *HSH Hotels* (2005) 58 ATR 276.

268 Certain assets were to be excluded from an entity's total property by virtue of section 56N(4) of the *Taxation (Administration) Act 1978* (NT). These assets were primarily liquid assets such as cash, negotiable instruments and loans.

269 *Alcan 1* (2007) 208 FLR 159, 184-85 [100].

the identifiable assets (other than land)[270] from the value of GAL's total non-excluded property to obtain a residual value for the remaining identifiable asset, the land.

Alcan's expert Mr Bryant made this point saying that a TDRM was the traditional means by which to value goodwill, not land. It is the methodology suggested by the *Murry* majority, although as they also pointed out, it requires that the identifiable assets be valued with some precision. This of course includes the land, which after all, was the actual subject matter of the land rich inquiry in *Alcan 1*. In Alcan's case this was difficult because GAL's land and fixtures were of the kind which did not transact in the market other than as part of a business and so there were no comparable sales or relevant market evidence upon which to rely. His Honour's reasons suggest that Mr Bryant valued GAL's land using an alternative methodology based on transfer pricing between a hypothetical mine business and a hypothetical refining business, and valued its fixed assets using a DRC (discounted replacement cost) methodology; although the transcript of the special leave application before the High Court indicates that if Mr Bryant did use this methodology, it was initially a methodology proposed by the Commissioner's expert Mr Lonergan.[271] Other than to reject both of Mr Bryant's methodologies, his Honour's reasons do not throw any light on the exact means by which Mr Bryant valued GAL's land. What they do show is that they resulted in a value for its share of the goodwill of the Gove joint venture business of between AUD$375 and $482 million, which even at the lesser amount, was sufficient to establish that less than 60% of the value of its property was land.[272]

The Commissioner denied that Mr Lonergan's TDRM was faulty and based upon a wrong assumption, submitting that it was inherently implausible that BHP Billiton[273] and Alcan were prepared to outlay some 48-55% of their purchase price, i.e. $380-400m above the value of the mine and refinery, to acquire something which was 'not an asset and was unidentifiable, unrealisable and intangible'.[274] He relied on Mr Lonergan's explanation that the excess of value identified by Mr Bryant between the value of the business (excluding chattels and working capital) and the value of GAL's identifiable assets (including its fixed assets at their DRC)[275] which he

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270 Primarily chattels and working capital.

271 Transcript of Proceedings, *Alcan Alumina (NT) Pty Ltd v Commissioner of Territory Revenue* [2009] HCATrans 076 (1 May 2009) 935-948 (DJS Jackson QC). Mr Lonergan is a proponent of this methodology which he calls 'shared economic returns' methodology in his book, *The Valuation of Mining Assets*, above n 265.

272 *Alcan 1* (2007) 208 FLR 159, 185 [101].

273 On 3 July 2000, Billiton Aluminium Australia Pty Ltd made an offer to acquire the share capital held in GAL by CSRI and on 4 July CSRI delivered to Alusuisse of Australia Ltd a complete copy of the offer pursuant to the provisions of the Parents and Subsidiaries Deed. The delivery of the Billiton offer by CSRI to Alusuisse of Australia Ltd constituted an offer by CSRI to sell the share capital that it held in GAL to Alusuisse of Australia Ltd in accordance with cl 3(b)(ii)(B) of the Parents and Subsidiaries Deed. Subsequently, Alusuisse of Australia Ltd accepted the CSRI offer and nominated the appellant Alcan to accept the offer as its nominee. See *Alcan 1* (2007) 208 FLR 159, 164 [13].

274 *Alcan 1* (2007) 208 FLR 159, 185 [101].

275 The DRC and its close relation the DORC are both founded on the principle of substitution and recognise that a prudent investor will pay no more for an asset than the cost to replace it new with an identical or similar unit of equivalent utility. Mildren J's reasons do not specify whether in fact the plant and machinery was valued on a DRC or DORC basis but given that any proper valuation of property, plant and equipment is required to address the issue of optimisation (See Farthing, above n 219), it is likely that GAL's plant was valued on this basis. Under the DORC approach, the market value of an asset is determined by reference to the reproduction or replacement cost

attributed to goodwill or unidentifiable intangible assets, was properly part of the income generating or 'in use' value of the fixed assets calculated on a DCF basis. They should therefore be treated as 'land'.

Although Mildren J found 'considerable force' in the Commissioner's submission,[276] its force depends on the particular facts. From an economics perspective, there is no simple means of predicting what fraction of the total value of a business is attributable to something other than its identifiable assets. For example, if the identifiable assets of a business are very location specific and have little or no resale value other than as scrap, it is possible as a matter of principle that virtually none of the total value of the business would be recouped in the separate sale of those assets. Similarly, if virtually all of the value of the business is in the knowledge of how to use common and readily available inputs to produce a product or service of value, and in the ability to do so without having to incur substantial start-up costs and assume relevant risks, these unidentifiable intangible assets would be the business's primary source of value and a significant source of its goodwill.

There is no simple rule to capture or apportion this particular share of value in a hypothetical transaction between a willing but not anxious buyer and seller. However, what is known, is that intangible assets, and in particular, knowledge-based intangible assets, are becoming more important and are contributing more value to businesses than ever before. The authors of the Brookings Report made this point when they said:

> In today's economy, economic growth is no longer being driven primarily by investments in physical assets such as factories, machines, office buildings, farm land and mineral resources. Instead, the factors most important to growth and societal wealth are intangible assets such as intellectual capital, research and development, brand names and human capital.
>
> Intangibles are harder to measure, quantify, manage and define than tangibles. For the most part they do not appear on the balance sheet on corporations. Nor are they recorded as part of the national wealth. There is no common language for talking about intangible sources of value, making it impossible to compare one institutional situation to the next. [277]

In the course of rejecting Alcan's arguments that it had accounting goodwill or unidentified intangible assets of any kind, Justice Mildren accepted Mr Lonergan's opinion that any difference between the present value of the future cash flows that an asset could generate and its DRC was not an intangible asset and should be properly reflected in the 'in use' value of the asset.[278]

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new (RCN) (also referred to as the gross current replacement cost (GCRC) of modern equivalent assets, optimised for over-design, over-capacity and redundant assets, and adjusted to reflect losses in value attributable to physical depreciation and obsolescence.

276 *Alcan 1* (2007) 208 FLR 159, 185 [101].

277 Blair and Wallman, above n 219. See also Tamara Plakalo, 'Untangling intangibles' (Society for Knowledge Economics background paper, 2006).

278 *Alcan 1* (2007) 208 FLR 159, 189 [120].

> Avoidance of a construction period, avoidance of ramping up production, expansion and optimisation possibilities and value of cash flows after the bauxite reserve is exhausted are all different ways of expressing the proposition that 'in use' value of an asset calculated on a DCF basis may be more than the DRC of the asset. They are aspects of the income yielding asset, not separate intangibles.[279]

There are a number of difficulties with this proposition. The first is that the future cash flows Mr Lonergan attributes to the fixed plant and equipment were not those of the plant and equipment alone, but represented the cash generating power of the business itself including all of its tangible and intangible assets and attributes. Without some or all of these assets and attributes, such as the trained and assembled workforce, experienced management, maintenance contracts, sales contracts, chattels, intellectual property, manufacturing and distribution techniques, know how etc, the plant and equipment was incapable of generating any cash flow other than perhaps if it was hired out or sold. Even if it was sold, the price paid would likely equal its DRC or some similar amount as it seems self-evident that no purchaser of GAL's plant and equipment would pay an amount for it which was equal to the cash generating power of the entire bauxite and alumina business enterprise. The majority in *Murry* made a similar point when they said that even if a particular asset of a business largely generates its cash flow, that cash flow would be unlikely to equal the cash generating power of the business itself such that if the asset was sold, the goodwill of the business would evaporate.[280]

The second difficulty with Mr Lonergan's opinion is that, as he points out, the DCF methodology values the plant and equipment at its value in use. However, as was made clear by the High Court in *Spencer v The Commonwealth of Australia* ('*Spencer*'),[281] when land or other property is valued for revenue purposes, it must be valued at its value in exchange and not at its value in use.

(a) DCF method of valuation

To properly understand the errors into which his Honour fell, it is necessary to briefly explain the DCF method of valuation. The DCF is an 'income approach' valuation methodology and is based upon the economic principle of anticipation (sometimes also called the principle of expectation). In this approach, the value of an asset is the present value of the expected economic income to be earned from the ownership of that asset. As the name of the principle implies, the investor anticipates the expected economic income to be earned from an investment in the asset. This expectation of prospective economic income is converted or 'discounted' to a present worth.[282]

According to Reilly and Schweihs, the most important consideration in any income approach analysis is to ensure that the measure of economic income (however defined) used in the valuation should represent only the income that relates to the asset the subject of the valuation.[283] For

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279 Ibid [119].
280 *Murry* (1998) 193 CLR 605, 625 [51].
281 (1907) 5 CLR 418.
282 Reilly and Schweihs, above n 219,113.
283 Ibid.

example, when valuing an identifiable intangible asset such as a trademark, the income stream should not include income earned by (or otherwise associated with):

(a) intangible assets other than the trademark;

(b) the overall business enterprise in which the trademark functions (unless an appropriate charge is made against the business enterprise income stream for the assets that are used or used up in the production of the trademark's income); or

(c) tangible assets that are used or used up in the production of the trademark's income (unless an appropriate capital charge is provided for in the income stream projection to allow for a fair allocation of the income (and the value) between the trademark and the associated tangible assets). [284]

In a recent article,[285] property plant and equipment valuer, Roy Farthing, makes a number of similar points about using an income approach to value plant and equipment. He notes that DCF methods are most commonly used to value businesses, however, when it becomes necessary to determine the value of the individual assets used to generate those cash flows, valuers typically consider that income-based approaches are generally only useful as a check method and that either a market comparison or cost approach should be applied. This is because income-based valuation approaches such as the DCF and earnings multiples approaches, value by default all assets, both tangible and intangible. Farthing illustrates his point by considering the example of two identical machines readily available in the market, each owned and operated by a different owner. Each machine has the capacity to produce an identical product at the same rate and cost. However Owner A has negotiated a favourable contract product sale price from which he will derive an income stream of x. Owner B has also negotiated a contract product sale price for a similar period but on less favourable terms. The net present value of the two income streams is quite different. Sales of comparable machines separate from the business in occupation are readily observable and are consistently less than the net present value of the cash flows of Owner A and Owner B. Farthing asks the question: is the machine owned by Owner A more valuable than that owned by Owner B? The business of Owner A is more valuable however the additional value is in respect of an intangible asset, most likely the supply contract, or goodwill and not because A's machine is suddenly more valuable.

The logic of this argument is generally self-evident where the market value of the assets used to derive the income stream is readily identifiable from the market place. However transactions involving the sale of specialised assets are relatively infrequent and when they do occur, the property, plant and equipment are sold as part of a going concern business. In such situations, the individual values attributable to the property, plant and equipment are typically not disclosed to the market. Farthing goes on to say that while specialised assets are typically used to produce income,

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284 Ibid.
285 Farthing, above n 219.

the income that is produced is consolidated in the overall business enterprise income and as such is produced by a combination of property, plant and equipment, and intangible assets functioning together as an integrated going concern business, and not by the specialised assets in isolation.

The difficulty identified by Farthing is expressly acknowledged by the API's Australian Valuation and Property Standards Board in its guidance note on the valuation of plant and equipment in which it states:

> It is recognised that it is rarely possible to identify an income stream and allocate it to individual assets. As a result, it is generally very difficult, if not impossible, to assess values of individual assets by reference to the income approach. It is also arguable that any cash flow based valuation will, by default, include more than just the plant and equipment assets. [286]

The importance of ensuring that the income stream of a business or the combined assets in a business is not improperly allocated to a discrete category of identifiable assets resulting in the value of those assets being inflated has also been recognised by Mr Lonergan in his own published works.

In a paper entitled 'Market Valuation of Business Assets – How to accurately value shares goodwill, brands, copyright, trademarks and other intangible assets', which he presented to an industry seminar in 1993, Mr Lonergan made a number of similar observations:

> The value of any asset is determined by the expected future earnings or cash flows that can be obtained from the use or resale of that asset. If an asset is to be valued in the absence of an established market in comparable assets, the future economic benefits from the employment of that asset must be capable of reasonable estimation. Although this is the same with respect to any business valuation, increased difficulty results from the requirement to segregate or allocate the future economic benefits related to the individual asset being valued from those other net assets that comprise the business.
>
> In practice, this results in the following three broad categories of difficulty. First, the asset being valued may have attached to it a clearly identifiable cash flow such as a royalty stream or lease payments that can be quantified, subject to the normal uncertainties inherent in the valuation process. Second, the asset may be employed with a number of other assets and the degree of difficulty and cost associated with determining a correct allocation of the future economic benefits to the individual assets needs to be considered with respect to the benefits of the valuation. Third, the future economic benefits may be so highly dependent on the other assets employed in the business that they are incapable of being properly segregated. [287]

After giving some examples, Mr Lonergan continued:

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[286] *International Valuation Guidance Note 3, Valuation of Plant and Equipment*, [5.1.4]. *Guidance Note* 3 has since been updated and carried forward to IVS 220 *Plant and Equipment* in the IVSC's new International Valuation Standards 2011 which became effective on 1 January 2012. IVS 220 makes a similar point in its Commentary at C.10.

[287] At 66-67.

> The professional valuer must therefore exercise proper judgment in allocating a composite intangible value between the unidentifiable and separate identifiable intangibles comprising the business.
>
> Furthermore, assets which are independent will often be sold together as a business. In such cases, the valuer must carefully consider the information available with respect to both assets in order to prepare a valuation allocating the value to the separate assets on a credible basis.
>
> Accordingly, great care also needs to be taken in distinguishing between the value of the intangible asset and the value of the synergistic benefits that might result through the combination of the asset with the other assets of the business, including those which are properly regarded as goodwill.[288]

In making these observations, Mr Lonergan concedes that when valuing an asset (tangible or intangible) using an income based approach such as the DCF, a valuer must ensure that he or she excludes from the valuation, the future economic benefits or income streams attributable to other assets, as well as the value of the synergistic benefits that might result through the combination of the subject asset with the other assets of the business. In *Alcan 1*, Mr Lonergan did not actually undertake any valuation of the Gove plant and equipment, but in attributing to it the value of all of the cash flow of the Gove business, with only some minor deductions for chattels and working capital, he failed to make the necessary exclusions. His methodology also appears to be at odds with his most recent text on the subject of valuing mining assets where he states that mining plant and equipment should be valued at its DRC or its DCF value *if this is lower* (emphasis added).[289]

(b) Using a DCF analysis to value assets of a business as opposed to the business

Leaving aside the fact that for the reasons discussed above, the cash flow referred to in *Alcan 1* was effectively the cash flow of the business rather than that of its plant and equipment, if that plant and equipment was in fact worth almost as much as the business itself, why would the joint venturers incur the costs and assume the risks of running the business at all? Why would they not close the business down and sell those assets for the value the Commissioner's expert assigned to them? Perhaps the answer to the question is because no reasonable purchaser would pay such an amount for those assets. First, because for the reasons already stated, the assets alone are incapable of generating the cash flow ascribed to them; and second, because even if they were, no purchaser would pay an amount for them equal to the present value of their anticipated future cash flow but would make deductions from that amount on account of both the profit he or she would expect to make from their acquisition and use, and to take into account the risk of realising the anticipated return.[290]

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288 Ibid.

289 Lonergan, *The Valuation of Mining Assets,* above n 265, 142.

290 *Turner v Minister of Public Instruction* (1955) 95 CLR 245, 289; *Minister for the Environment v Florence* (1979) 21 SASR 108, 131; *Port Stephens Shire Council v Tellamist Pty Ltd* (2004) 135 LGERA 98 [227] (Ipp J). *Heavey Lex No 64 Pty Ltd v Chief Executive, Department of Transport* (1999) 20 QLCR 296, 336-337. See also *City of Adelaide v City of Port Adelaide Enfield* (2001) 115 LGERA 137, 149 (Debelle J).

In *City of Adelaide v City of Port Adelaide Enfield*,[291] Debelle J (Olsson and Williams JJ agreeing) explained why an allowance should be made for profit when using the DCF method to value an asset (in this case, land):

> [T]here is a difference between the value of the business and the price to be paid for the land on which the business will be run. As Mr Douglas Brown points out in his text *Land Acquisition* (4th ed, 1996) par 4.16, a prudent purchaser concerned not to overlook ordinary business considerations would base his price, not on the nett return, but upon a figure somewhat lower than the nett sale price of the land in subdivided form. If he did not, he would be paying as much for the land as he believed he would be receiving for it when subdivided. In my view, an allowance for profit should be made. [292]

Kitto J put it even more succinctly in *Turner v Minister of Public Instruction* ('*Turner*')[293] where he stated the seemingly obvious:

> No one is going to buy an area of land to sell it in subdivision if he has to pay as much for it as he thinks he can prudently count on getting back. Why should he bother, if he is not going to make a profit?[294]

In the same case, Kitto J also explained the reasons why a purchaser would make an allowance for the risk of realisation:

> The net return which the land 'might well have been expected' at the relevant date to produce at a period possibly nine or ten months later, and after the expenditure of sums uncertain in amount, is therefore not a figure upon which a person concerned not to overlook ordinary business considerations could prudently accept as a basis for a decision to buy or sell the land as a whole or to keep it for sale by a more advantageous method. He would not need to be reminded that what may well be expected, on the basis of such intelligent prophecy as the known facts permit, and what can fairly be counted upon, are two very different things. Any or all of the assumptions that are reflected in his final figure might easily be falsified by events. Inevitably he would base his thinking upon a figure somewhat lower than the net sale price which he had reached on paper. [295]

In the present case, the cash flow of the Gove business was not forecast a mere nine or ten months in advance as it was in Turner. Nor was it confined to the risks involved in the comparatively simple business of subdividing and selling a parcel of land. Instead it was forecast many years in advance, and was subject to the vicissitudes of the volatile commodities markets for bauxite and aluminium. It was also affected by a number of idiosyncratic[296] and systematic risks,[297] many of which could not be alleviated by choice of discount rate in a DCF calculation.

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291 (2001) 115 LGERA 137.

292 Ibid 149 (Debelle J). See also *Redwood Court Pty Ltd v Roads Corp* (1992) 76 LGRA 358, 361 (Gobbo J): 'If this test is applied, it is obvious that the owner would settle on a lower figure than the total of future potential profits. The price he would pay would reflect the certainty of payment against the risks of realisation of a potential return and, also, in some cases, the benefit of present payment.'

293 (1955) 95 CLR 245.

294 Ibid 290.

295 Ibid 289-290.

296 Idiosyncratic risks are risks which are not correlated with other movements in the market. While the presence of idiosyncratic risk must be taken into account when calculating the expected value of a series of cash flows, it will

In these circumstances, what seems 'inherently implausible' is that a purchaser of GAL's fixed assets would pay an amount for them equivalent to the total value of the projected future cash flow of the business enterprise without taking into account the cost (in terms of time and money) of acquiring the other assets of the business necessary to produce the projected cash flow, and without seeking a deduction on account of both anticipated profit and potential risks.

(c) The Spencer test of value

Justice Mildren's acceptance of a 'value in use' for GAL's interest in the Gove business's fixed assets obtained by using a DCF methodology is not only flawed from a valuation perspective, it is also flawed on legal grounds. When the value of land or other property is to be ascertained for revenue (among other) purposes, it is to be valued in accordance with the test articulated by the High Court in *Spencer*. *Spencer* requires that the property be valued at its value in exchange or market value (as opposed to its value in use). It asks:

> What would a hypothetical prudent purchaser be prepared to give a hypothetical prudent vendor, not by means of a forced sale, but by voluntary bargaining, both parties being willing to trade, but neither being so anxious to do so that he or she would overlook any ordinary business consideration, and both parties being cognizant of all circumstances which might affect value?[298]

The *Spencer* test of market value is reflected in the definition of 'market value' in the IVSC's IVS 1 *Market Value Basis of Valuation*. Calling market value a 'representation of value in exchange',[299] IVS 1 defines market value as:

> The estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arms' length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.[300]

The API and NZPI have adopted this definition in their Valuation and Property Standards on the basis that it paraphrases the elements of market value as defined in *Spencer* and includes the essential elements of that definition.[301]

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not affect the discount rate that must be applied to the expected value of those cash flows to determine the amount an investor would be willing to pay for the rights to those cash flows. However, even if the cash flow of one investment is affected by a particular idiosyncratic risk and another isn't, finance theory, as expressed by the widely accepted Capital Asset Pricing Model holds that the discount rate that is used to determine the amount that investors would be willing to pay for the rights to either cash flow would be the same, despite the fact that there is far more risk associated with one investment than the other, because they can cause the variability in the returns on their portfolio to disappear by assembling broadly diversified portfolios. See Richard A. Brealey, Stewart C. Myers and Franklin Allen, *Principles of Corporate Finance (*9th Ed, McGraw-Hill 2008) 214.

297 Systematic risks are risks which cannot be eliminated through diversification. For example, the return on an investment may depend on the state of the world economy, which also affects the value of many other investments. Since they cannot eliminate the uncertainty associated with those risks through diversification, investors will require compensation for bearing these risks.

298 *Spencer* (1907] 5 CLR 418, 432 and 441 (Griffiths CJ and Isaacs J) cited in *Perpetual Trustee Co Ltd v FCT* (1942] 65 CLR 572, 579; *Abrahams v FCT* (1944] 70 CLR 23, 29; *The Executors of the Estate of Crane v FCT* (1974] 5 ALR 38, 41; *Nischu Pty Ltd v Commissioner of State Taxation (WA)* (1990) 90 ATC 4391.

299 IVSC, International Valuation Standards Sixth Edition, 2003, IVS1 Market value basis of valuation, s1.2. The current IVS standard is IVS 2011 which became effective on 1 January 2012. The definition of market value in IVS 2011 is found in the IVS Framework at [30] and is unchanged.

300 Ibid s3.1.

Meanwhile IVS 2 *Valuation Bases Other than Market Value* defines 'value in use' as:

> The value a specific property has for a specific use to a specific user, and is therefore, non-market related. This value type focuses on the value that specific property contributes to the entity of which it is a part, without regard to the property's highest and best use, or the monetary amount which might be realised upon its sale.[302]

'Value in use' is also an accounting term. In both AASB 136 *Impairment of Assets*, and IAS 36, the international standard of the same name on which it is based, value in use is defined as 'the present value of the future cash flows expected to be derived from an asset or cash generating unit. In contrast, 'Fair value less cost to sell' is defined as the amount obtainable from the sale of an asset or cash generating unit in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.[303] It seems clear that when the Commissioner's expert opined that GAL's plant and equipment be valued at its 'value in use' or 'cash generating value' he was applying an accounting standard of value rather than a legal standard of value.

In Australia, when land or property is valued for revenue and most other legal purposes, it is valued at its market value or 'value in exchange'.[304] For example in *Peko-Wallsend Operations Ltd v Commissioner of State Taxation (WA)* ('*Peko-Wallsend*'),[305] Kennedy J accepted as correct the approach suggested by the Commissioner's expert witness who was asked to value iron ore sales contracts. He said, without any further analysis or discussion: 'Mr Robinson distinguished between value in use (or value to the owner) and value in exchange (or market value), which is the value required in this case of the authority of *Spencer v the Commonwealth*.'[306] The other two members of the court, Brinsden and Rowland JJ did not specifically address the issue although Brinsden J approved and applied the *Spencer* test of market value.

Similarly, in *Commissioner of State Taxation (WA) v Nischu Pty Ltd*, ('*Nischu 2*')[307] a land rich stamp duty appeal heard by the Full Court of the Western Australian Supreme Court, Malcolm CJ, after referring to *Spencer* and several other cases, said 'it is the value in exchange and not the value in use which is to be ascertained' citing as authority Kennedy in *Peko-Wallsend*.[308]

Importantly, *Spencer* does not permit the profits or losses generated by a business conducted on land to be included as a component of the market value of the land. This was confirmed by the Privy Council in *Pastoral Finance Association Ltd v The Minister*,[309] and subsequently by the High

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301 Australian Property Institute & New Zealand Property Institute, 2006 Professional Practice, 'Instructing Valuers', 423. The API and NZPI have adopted the new IVS 2011 from 1 January 2012.

302 IVSC, International Valuation Standards Sixth Edition, 2003, IVS2 *Valuation bases other than market value*, s3.1.

303 AASB 136 *Impairment of Assets* (2009) [6].

304 See *Nischu Pty Ltd v Commissioner of State Taxation (WA)* (1990) 90 ATC 4391, 4395-6; *Peko-Wallsend Operations Ltd v Commissioner of State Taxation (WA)* (1989) 20 ATR 823, 844-845; *MIM Holdings Pty Ltd v Commissioner of Stamp Duties* (1998) 41 ATR 50, 64; *Emerson v Custom Credit Corporation Ltd* (1994) 1 Qd R 516, 521.

305 (1989) 20 ATR 823.

306 Ibid 844.

307 (1991) 4 WAR 437.

308 Ibid 443.

309 [1914] AC 1083.

Court in *Commissioner of Land Tax v Nathan*[310] where, speaking for a bench comprised of Barton ACJ, Isaacs, Gavan Duffy and Rich JJ, Isaacs J warned against including in the value arrived at by application of the *Spencer* test, the amounts of profits or losses which are being made from use of the land in question saying:

> The ordinary principle of ascertaining the value of land on a given date is stated in *Spencer v. The Commonwealth* at p. 441, in these words, from which we see no reason to depart:--'To arrive at the value of the land at that date, we have, as I conceive, to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser, willing to trade, but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land, and cognizant of all circumstances which might affect its value, either advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood, as then appearing to persons best capable of forming an opinion, of a rise or fall for what reason soever in the amount which one would otherwise be willing to fix as the value of the property.
>
> The amount of profits or losses which actually at that date are being made does not constitute the test, because into them possibly enters the element of the personal skill or popularity of the present owner, and similar circumstances which cease when his ownership ceases; but, though not the test, no prudent man would fail to inquire into them, and weigh the fact for himself. [311]

It is no more permissible to include in a market valuation of plant and machinery, the value of the anticipated profits which might be earned by using that plant and machinery in a business, as it is to include the value of anticipated profits from land in a market valuation of the land.

In ascribing a value to GAL's interest in the Gove plant and equipment equal almost to that of its interest in the business, the Commissioner wrongly included in that value all of the profits of the bauxite and alumina business in which the assets were used. This contravenes the *Spencer* test and rather than produce a market value for the plant and equipment, results in a value for the business itself.

7. The absence of an entry for goodwill on its balance sheet is evidence that a business has no accounting goodwill

In reaching his conclusion that the Gove business no accounting goodwill, Justice Mildren took comfort in the fact that nowhere in GAL's balance sheets was there a reference to goodwill as a business asset, [312] and that nowhere in the reports relied upon by Alcan or in the submissions of its Counsel was it asserted that the Gove business had any goodwill 'in the legal sense explained in

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310 (1913) 16 CLR 654.
311 Ibid 661.
312 *Alcan 1* (2007) 208 FLR 159, 185-86 [106].

Federal Commissioner of Taxation v Murry'. In particular, he pointed out that Alcan's expert, Mr Bryant had conceded that it had no goodwill 'in the sense of a tendency to attract customers'.[313]

That no goodwill was recorded in a balance sheet is not unusual as for the reasons stated previously in this thesis,[314] Australian Accounting Standards do not permit internally generated goodwill to be recorded on a company's balance sheet.[315] Even purchased goodwill is not necessarily recorded in the form of goodwill as companies often prefer to attribute its value to tangible assets for taxation or other purposes.

According to AASB 138, internally generated goodwill is not recognised as an asset because it is 'not an identifiable resource (i.e. it is not separable nor does it arise from contractual or other legal rights) controlled by the entity that can be measured reliably at cost'.[316]

Other reasons for the prohibition on recording internally generated goodwill were suggested by Mr Lonergan in an article published by him in 1995:

> In a successful business, goodwill is nurtured and grows. Yet accounting standards worldwide preclude the recognition of this internally generated goodwill. The reason for forbidding the recognition of internally generated goodwill is simple. If its recognition were permitted it would lead to widespread overstatement of reported results. Simply put, the value of internally generated goodwill is so difficult to measure that its recognition is forbidden in all major countries of the world.[317]

In relation to purchased goodwill, it is both well-known and well documented that for many decades, reporting practices have been contentious and often at odds with the apparent letter and spirit of a variety of relevant regulatory pronouncements relevant to goodwill accounting and reporting. In particular, it is widely accepted in the literature dealing with financial reporting that many entities engaged in business acquisitions have for many years made strenuous efforts to avoid the recognition of goodwill arising from acquisition because of the adverse post acquisition impact of goodwill compared to other asset classes which could either be amortised against profit over longer periods than goodwill or in relation to which there were no formal requirements for annual amortisation charges.[318] For these reasons, some commentators refer to goodwill as 'the black sheep of the balance sheet'.[319]

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313 Ibid 186 [108]. Note that this concession was explained by Counsel for Alcan in the course of the hearing of the parties' special leave applications as 'In the sense that the location of the business did not bring in customers in the sense of passing trade …': Transcript of Proceedings, *Alcan Alumina (NT) Pty Ltd v Commissioner of Territory Revenue* [2009] HCATrans 076 (1 May 2009) 905-924 (DJS Jackson QC).

314 See Section III C 4 above.

315 AASB 138 maintains the traditional approach to internally generated goodwill which is that 'Goodwill which is internally generated shall not be recognised as an asset': AASB 138 (2009) [48].

316 Ibid.

317 Wayne Lonergan, 'Goodwill and Bad Ideas; Fact and Fiction in the Amortisation Debate' (1995)4 *JASSA* 2-7.

318 See as examples: C Hayn and P Hughes, 'Leading Indicators of Goodwill Impairment' (2006) 21(3) *Journal of Accounting, Auditing and Finance*, 223-265; M Massoud and C Rayborn, 'Accounting for Goodwill, Are We Better Off? A Discussion of New Goodwill Rules for Accounting' (2003) 24(2) *Review of Business* 26-33; G

In his book, ‘*The Valuation of Mining Assets*’,[320] Mr Lonergan seems to agree saying:

> More importantly for decades corporate Australia has had an obsession with the recognition of goodwill and has gone out of its way to avoid recognition and subsequent annual amortisation charge. The reasons for this obsession are difficult to fathom because, as the amortisation charge has no impact on cash flow it cannot, by its very nature, affect value.
>
> Historically, amortising goodwill may have restricted the ability of some companies to pay out all their surplus cash as dividends. However, since the implementation of the share buy-back legislation this is now rarely a problem.
>
> However, the simple fact is that corporate Australia has historically gone out of its way to avoid recognising goodwill for accounting purposes. As a result significant, and often overstated, values have been attributed to other identifiable intangible (and sometimes tangible) assets.[321]

In the same text, Mr Lonergan sets out a long list of additional financial benefits from which goodwill is derived in a mining company but which will not be recognised normally in the mining company's financial statements. These include:

(a) The quality of management including their respective skills and experience in the industry;

(b) The configuration of the plant and equipment so that maximum economic benefit is obtained;

(c) The geographical location of the targets operations. This includes the possibility that economies of scale can be obtained if deposits are close or adjacent to others held by the bidder and the impact that this has on operating costs and/or equipment and capital requirements;

(d) Technical skills of management and senior staff, including, in particular, the specific skills of the company's geologists;

(e) The technical database, mining information and exploration information;

(f) Technological skills;

(g) Risk management ability including trading and treasury skills;

(h) Reputation and the impact that this can have in attracting talented management and staff;

(i) Capital raising ability (including the relative cost of capital) and the impact that this may have in being able to exploit speedily and effectively any discoveries;

Wines, R Dagwell and C Windsor, ‘Implications of the IFRS Goodwill Accounting Treatment’ (2007) 22(9) *Managerial Auditing Journal* 862-880.

319 Tyrone M Carlin, Nigel Finch and Guy Ford, ‘Goodwill Impairment – An Assessment of Disclosure Quality and Compliance Levels by Large Listed Australian Firms’ (MGSM Working Paper 2007-8).

320 Lonergan, *The Valuation of Mining Assets,* above n 265.

321 Ibid 156. See also Wayne Lonergan, ‘Why Goodwill accounting changes are a farce’ (2004) <http://www.aph.gov.au/Senate/committee/corporations_ctte/completed_inquiries/2004-07/aas/submissions/sub24.pdf>.

(j) By being an existing company with existing cash flows, the target may be able to exploit discoveries at a faster rate than if the discovery had been made by a company without a cash flow. The cash flows generated from the exploitation of further discoveries can be earned at a faster rate than would otherwise have been possible (this is a time value of money and risk issue;

(k) Synergy benefits arising out of cost savings (for example, savings in directors' fees, listing fees etc);

(l) An option over future movements in the commodity's price;

(m) The ability to generate profits by entering into forward sale agreements (or other commodity based financial instruments) over the target company's future production; and

(n) The value of any excess franking credits.[322]

In the present case, the Gove joint venture was not a simple mining operation. It was both a large scale upstream mining operation and a sophisticated downstream mineral processing operation. It is likely that it possessed at least some of the sources of goodwill identified by Mr Lonergan. Such a submission may have been made to Justice Mildren, but if it was, his Honour did not mention it in his reasons.

Even so, it is plain that the *Murry* majority recognised that a business may have goodwill despite it not being recorded in its accounts stating '[i]t is clear as a matter of legal principle that a business may have goodwill although it is not shown in the accounts of the business'.[323] Despite this, Mildren J treated the absence of an entry for goodwill in GAL's books as evidence that even for accounting purposes, the business had no asset in the form of goodwill.

E. The conclusion

In deciding the case, Justice Mildren found against Alcan on the goodwill grounds, but allowed the appeal on the basis that an option to renew a mineral lease does not fall within the statutory definition of 'land' in Division 8A of the *Taxation (Administration) Act* 1978 (NT). He remitted the matter to the Commissioner for reconsideration in light of this finding. The parties came back before his Honour in *Alcan (NT) Alumina Pty Ltd v Commissioner of Taxes (No 3)*[324] where Justice Mildren heard evidence from both parties as to the value of GAL's land excluding the options to renew the leases. He accepted Alcan's evidence and found that the value of its land did not exceed 60% of the value of its property. Consequently, he upheld Alcan's appeal and set the Commissioner's assessment aside.

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322 Lonergan, *The Valuation of Mining Assets* above n 265, 154-55.
323 *Murry* (1998) 193 CLR 605,624 [47].
324 (2007) 67 ATR 664.

VII. ALCAN IN THE NORTHERN TERRITORY COURT OF APPEAL

The Commissioner appealed Justice Mildren's decision to the Court of Appeal in *Alcan 2*.

A. Background

In *Alcan 2*, the Commissioner contested the trial judge's finding that an option to renew a lease could not be included when determining the value of land held by GAL. Alcan filed a Notice of Cross Contention alleging errors by the judge in finding that GAL did not have an entitlement to property in the form of goodwill. Specifically, Alcan submitted that the trial judge erred in finding that the 'attraction of custom is an essential element of the legal concept of goodwill such that if it does not exist legal goodwill cannot exist'. Alcan contended that sources of goodwill which did not depend upon custom existed in the Gove joint venture business and that these comprised goodwill in the legal sense.

The appeal court unanimously upheld the Commissioner's appeal, and by a two to one majority, upheld Alcan's cross contention. The result was that once again Alcan avoided liability for land rich duty. It is Alcan's successful cross contention concerning its entitlement to goodwill which is of interest in this thesis.

B. The dissenting judgment

In his dissenting judgment, Martin CJ approved Justice Mildren's patronage approach to goodwill and agreed that no goodwill existed in the Gove joint venture business. In his view, although the business had attributes which might ordinarily establish the existence of goodwill, there was no evidence to establish that those attributes had attracted custom to the business.

His Honour stated that Mildren J had correctly identified goodwill in the legal sense as property and an asset in its own right. He said that his Honour had reviewed the evidence concerning the value of GAL's assets, made findings which had not been subsequently challenged on appeal, and had correctly concluded that GAL had no entitlement to goodwill because there was 'no evidence that GAL had an attractive force that brought in custom and which added to the value of the business'.[325]

His Honour went on to say that while Justice Mildren did not define goodwill by reference to 'the legal right or privilege as discussed in *Murry'*, nevertheless he correctly identified the relevant question by approaching his determination on the basis that attraction of custom still remains central to the legal concept of goodwill.[326] In the Chief Justice's opinion, the trial judge's approach was not inappropriately constrained by an unduly narrow view of goodwill in the legal sense. Alcan

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325 *Alcan 2* [2008] 24 NTLR 33, 62 [84].
326 Ibid 63 [85].

could not prove that the Gove business used its tangible assets to draw custom to the business and therefore it had no goodwill in the legal sense.[327]

Martin CJ went on to consider whether the business had goodwill from sources other than its tangible assets. These other sources of goodwill or intangible assets involved primarily methodologies, know-how and expansion possibilities.[328]

His Honour found that even though such items may have had value, particularly to a purchaser of the business, they did not support a finding of legal goodwill. This was because some of the items were merely aspects of the income yielding asset and not separate intangibles, and in any event, there was no evidence that any of the items attracted customers to the business. [329] His Honour did not go on to consider where or to what the value of these items should be allocated and therefore by virtue of the TDRM of valuation employed by the Commissioner's expert, their value automatically fell into the residual value of GAL's land.

Ultimately, like the trial judge before him, the Chief Justice was not persuaded that there were any intangible assets which together or separately had any existence as property and which needed to be accounted for and separately valued.[330] In reaching his decision, his Honour noted that while it might seem odd that the profitable business of the joint venture could operate without the existence of legal goodwill, in his opinion the trial judge was correct in concluding that the evidence was incapable of supporting a conclusion that there were sources of goodwill within the business which, individually, or in combination, attracted customers to that business.[331] While the legal right or privilege to conduct the business purchased by Alcan involved the right to do so in the same manner and by substantially the same means as the previous owners, there was no evidence that such manner and means had attracted custom to the business. There was no evidence that the combination and use of the tangible, intangible and human assets of the business had resulted in custom being drawn to the business. In these circumstances there was no evidence that GAL had property in the form of goodwill in the legal sense.[332]

C. The majority judgments

Both Angel J and Southwood J disagreed in separately written judgments in which the former endorsed an added value approach to goodwill, and the latter, a hybrid approach which encompassed elements of both the patronage and added value approaches.

In his judgment, Angel J noted that the accounting experts called by the parties agreed that according to ordinary valuation principles there was some significant difference between the

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327 Ibid.
328 Ibid 65 [99].
329 Ibid 66 [101].
330 *Alcan 1* (2007) 208 FLR 159, 189 [121]; *Alcan 2* [2008] 24 NTLR 33, 66 [102].
331 *Alcan 2* [2008] 24 NTLR 33, 65 [97].
332 Ibid 65 [97].

purchase price paid for the business and the sum of the individual values of the tangible assets of the business. This difference Mr Bryant attributed to the intangible asset of goodwill whereas Mr Lonergan called the difference 'unallocated residual value' which he considered should be added to the value of the business's tangible fixed assets.[333]

His Honour also noted that while Mr Bryant had valued the tangible assets before ascribing the balance to goodwill[334] drawn from a number of identified sources, Mr Lonergan contended that it was not necessary to calculate separate values for the various assets. This was because in his view, all the value of the business (other than those items comprising vehicles, tools and other loose and unfixed items) should be attributed to land in form of the mining lease and the fixed mining and refinery plant and equipment.[335] Ascertaining the value of the land merely required one to deduct the value of the vehicles, tools and other items from the total value of the business. In those circumstances it was unnecessary to separate value the lease and fixed plant and equipment.

This was because in Mr Lonergan's opinion, the revenue from the facility was principally due to the particular quantities and qualities of the bauxite reserves including the specific chemical characteristics of the ore body, the proximity of the refinery to the mine and the proximity of the ore body to a deep water port which ensured the refinery was a low cost producer. In his view, all of these benefits should be reflected in the value of the land.[336]

Justice Angel criticised Mr Lonergan's analysis on the basis that it failed to segregate goodwill from its sources and wrongly equated them for legal purposes.[337] He also considered that the approach discounted site goodwill altogether saying that Gove's closer proximity to India, China and Japan than South American and Caribbean competitors in the bauxite/alumina world market and Australia's political stability could not count for nothing.[338] Justice Angel was also unimpressed by Mr Lonergan's TDRM which he said dispensed with the necessity to value identifiable assets, failed to separate goodwill from its sources, and so 'jumble[d] goodwill with its sources'.[339] Justice Angel did not go on to deal further with the issue of site goodwill, but given that he considered that Mr Lonergan had failed to segregate goodwill from its sources, it seems likely that his Honour considered site goodwill to be a separate asset from the land and not simply a value enhancement.[340]

Justice Angel also rejected Mr Lonergan's contention that an operation such as that conducted by the Gove joint venturers had no intangible assets or goodwill. He said that according to published

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333 Ibid 68 [111].
334 Being legal goodwill, or alternatively, accounting goodwill, neither of which was land.
335 *Alcan 2* [2008] 24 NTLR 33, 68 [111].
336 Ibid 67 [109].
337 Ibid.
338 Ibid 68 [109].
339 ibid 70 [116].
340 Cf *Kizleap* [2001] NSWSC 80*; Morvic* [2002] ATC 4459*; Palace Hotel* (2004) 8 VR 439; and *HSH Hotels* (2005) 58 ATR 276*.*

reports referred to in Price Waterhouse Coopers Report of 15 May 2002, Australia is the major producer of bauxite in the world. In 2000 Australia provided 39 per cent of world output. In regional terms output from South America/the Caribbean was the second largest after Australia with 26 per cent of world output. Furthermore Australia is a competitive supplier of bauxite because of the favourable properties of its bauxite deposits and its relative economic competitiveness and political stability. Gove is one of a number of large accessible deposits of bauxite and Australian bauxite mines are relatively large–scale by international standards enabling them to take advantage of economies of scale. Australia also has a comparative advantage in alumina refining stemming from its relatively low cost energy supplies (particularly natural gas) and its relatively low bauxite mining costs due to the availability of in situ bauxite. The Gove alumina refinery is one of six in Australia which are among the largest refineries in the world. Justice Angel said that these matters were all taken into account by Alcan's expert witness Mr Bryant, and in his Honour's view, supported the existence of substantial goodwill in the business operated by GAL.[341]

Turning to the decision in *Murry*, his Honour cited the majority's statement that the courts 'have rejected patronage as the touchstone of goodwill in favour of the ''added value'' concept'[342] and treat goodwill as 'the valuable right or privilege to use the other assets of the business as a business to produce income'.[343] Under this concept, the existence of legal goodwill depends upon 'proof that the business generates and is likely to continue to generate earnings from the use of its identifiable assets, locations, people, efficiencies, systems, processes and techniques of the business'.[344] When a person acquires the legal right or privilege to conduct that business in substantially the same manner and by substantially the same means which in the past have attracted custom to the business, a person acquires goodwill for legal purposes.[345] The Gove business did generate earnings from the use of its assets and attributes and would continue to do so in the foreseeable future. By acquiring the shares in GAL, Alcan had acquired the legal right or privilege to conduct that business and generate those earnings, and so had acquired goodwill for legal purposes. Such goodwill could be measured by the normal accounting method of deducting the value of GAL's interest in the business's identifiable assets from the price paid for its interest in the Gove joint venture business.[346]

Importantly, Angel J observed that a business which has ongoing business patronage or support has custom and it is irrelevant from whence that custom comes.[347] He disagreed with the contention that a business which sells a commodity product could not have goodwill, saying that such an argument was inconsistent with the want or need for long term contracts for the supply of alumina.

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341 *Alcan 2* [2008] 24 NTLR 33, 68 [110].
342 Ibid 69 [114] citing *Murry* at 614 [20].
343 Ibid citing *Murry* at 615 [23].
344 *Murry* (1998) 193 CLR 605, 611 [12]. See above n 77.
345 *Alcan 2* [2008] 24 NTLR 33, 68 [112].
346 Ibid 69-70 [116].
347 Ibid 69 [115].

Nor was the identity of customers relevant or whether the product sold is readily available at the same price elsewhere. He said if A profits more than X Y and Z from selling the same product at the same price, then A has a more valuable business than X Y or Z, and this is so regardless of to whom A sells.[348]

In summary, Angel J made the following findings about goodwill for legal purposes:

(a) The existence of goodwill depends upon proof that the business generates and is likely to continue to generate earnings from any number of sources including the use of the identifiable assets, locations, people, efficiencies, systems, processes and techniques of the business.[349]

(b) Where a business has ongoing business patronage or support, it necessarily has custom.[350]

(c) The identity of the customer or customers of the business does not determine whether a business has goodwill.[351]

(d) The 'attraction of custom' includes the maintenance of existing custom.[352]

(e) The fact that the product sold by the business is a commodity product or is readily available at the same price elsewhere is irrelevant to the question of the existence of goodwill.[353]

(f) The appropriate method to value goodwill in a profitable business is as a residual by applying the conventional accounting approach of ascertaining the difference between the value of the enterprise and the value of its underlying identifiable assets.[354]

For all of these reasons, his Honour found that GAL had an entitlement to substantial valuable goodwill and so he upheld Alcan's Notice of Contention. He remitted the matter to the Commissioner to reassess the transaction and ascertain the value of the relevant goodwill in accordance with the conventional accounting approach.[355]

Justice Southwood agreed with Justice Angel's conclusion but delivered reasons of his own in which he favoured a hybrid approach which attempted to accommodate elements of both the patronage and added value approaches. He found that there were two principal questions in relation to the Notice of Contention.[356] First, did the business of GAL attract custom? Second, did the advantageous circumstances identified by Mr Bryant (avoidance of a construction period,

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348 Ibid 67 [108].
349 Ibid 68 [112].
350 Ibid 69 [115].
351 Ibid.
352 Ibid 70 [117].
353 Ibid 67 [108].
354 Ibid 69-70 [116].
355 Ibid 70 [117], [119].
356 Ibid 71 [127].

avoidance of ramping up production, expansion and optimisation possibilities and value of cash flows after the bauxite reserve is exhausted) create, maintain, expand or increase the custom of the business or do they have the potential to do so and thereby generate earnings? His Honour claimed that if these two principal issues were resolved in Alcan's favour it would avoid the necessity to resolve a number of other issues which potentially arose for determination on Alcan's Notice of Contention being:

(a) What advantageous circumstances (sources) are to be included in the recognition of goodwill?

(b) To be included as a source of goodwill, must the advantageous circumstances directly or indirectly create, maintain, expand or increase favourable customer attitudes?

(c) Is it sufficient for a favourable advantageous circumstance to be included as a source of goodwill if it merely increases the income or earnings of a business?

(d) Can a business have goodwill if it only has one customer?

(e) Is repeat custom a necessary requirement of goodwill? [357]

His Honour went on to resolve the two principal issues by first outlining the arguments of the parties on the appeal. He said that the remarks of Judge Swan in the US case of *Haberle Crystal Springs Brewing Co v Clarke*[358] quoted by the High Court in *Murry*[359] presented three ideas that are associated with the nature of goodwill: (1) excess value; (2) favourable customer relations; and (3) the privilege of continuance. The three ideas are presented as distinct and severable ideas. Judge Swan ultimately held that goodwill is in effect confined to patronage or favourable customer relations. Such a privilege he said was property of value.[360]

Justice Southwood said that the Commissioner's argument was to the effect that the High Court's decision in *Murry* had confined the legal concept of goodwill in Australia to the second and third ideas referred to by Judge Swan, and that these form an integrated whole. Both favourable customer relations and the privilege of continuance are required for goodwill to exist. However in the present case, the Commissioner argued that GAL had no entitlement to goodwill as the Gove business had no attractive force which brought in custom, firstly because it sold a commodity product, and secondly because the joint venturers sold most of that product to related parties under long term sales contracts. Using the language of Judge Swan, the business had no goodwill because it had no favourable customer relations.[361]

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357 Ibid 72 [128].

358 30 F 2d 219 (2d Cir,1929) 221-222 which was reversed on appeal on unrelated grounds in *Clarke v Haberle Crystal Springs Brewing Co*, 280 US 384 (1930).

359 *Murry* (1998) 193 CLR 605, 614 [19].

360 *Alcan 2* [2008] 24 NTLR 33, 72 [130].

361 Ibid 72 [131].

Justice Southwood observed that support for the Commissioner's position that both favourable customer relations and the privilege of continuance are required for goodwill to exist could be found in a number of statements of the majority of the High Court in *Murry,* including their statement that 'the attraction of custom still remains central to the legal concept of goodwill'.[362]

However, his Honour noted that such a conceptual approach potentially creates difficulties where the property and patronage elements of an operating business do not exhaust the intangible value of the business. This is because the judge considered that such an approach left 'no room for benefits or positive advantages which may arise from the continuity of organisation of the business such as good relations with suppliers of the business, good industrial relations, the quality of management, the configuration of plant and equipment, the technical skills of management and senior staff, technological skills, credit management and capital raising ability, all of which may add value to the business by reducing costs and increasing profits without necessarily maintaining or increasing custom'.[363] Further, in the judge's view, a business could be successful and create excess value without substantial customer preference.[364]

Southwood J considered these benefits or advantages to be part of what he called 'going value' rather than sources of goodwill in a *Murry* sense. In the circumstances of the case, he found it unnecessary to decide if going value was 'another form of parasitic incorporeal property that may be obtained by acquiring the right to conduct a business in substantially the same manner and by substantially the same means'.[365] This concept of going value or 'going concern value' is not novel and will be discussed in some detail shortly.

Turning to Alcan's arguments, Southwood J understood Alcan to contend that first, 'the attraction of custom' is not an essential element of the legal concept of goodwill such that if it does not exist legal goodwill can still exist; and second, assuming that both the privilege of established customer relations and the privilege of continuity are required for goodwill to exist, the establishment of repeat custom is not a necessary requirement, at least not in the context of the valuation of a profitable operating business.[366]

Rather, Alcan argued that *Murry* had stated that whether or not goodwill exists depends upon proof that the business generates, and is likely to continue to generate, earnings from the use of identifiable assets, locations, people, efficiencies, systems, processes and techniques of the

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362 *Murry* (1998) 193 CLR 605, 614 [19]. See also 615 [23], [45] and 630 [68]; *Alcan 2* (2008) 24 NTLR 33, 72 [132].

363 *Alcan 2* (2008) 24 NTLR 33, 73 [133].

364 Ibid.

365 Ibid. In his footnote to [133], Southwood J explained what he meant by 'going value': 'Various courts in the United States of America have defined 'going value' as the value which inheres in an assembled and established plant, doing business and earning money, over one not thus advanced. There is a discussion of this concept in Note, 'An Inquiry into the Nature of Goodwill', Columbia Law Review, vol. 53 (1953) 660. The author of the note suggests that on various occasions the courts in the United States of America may have recognized 'going value' as a separate incorporeal property right. The cases referred to by the author include: *McCardle v. Indianapolis Water Co.*, 272 U.S. 400, 414 (1926); *Des Moines Gas Co. v. Des Moines* 238 U.S.153, 165 (1915).'

366 *Alcan 2* (2008) 24 NTLR 33, 73-4 [134]-[135].

business.[367] And as Dixon CJ, Williams, Fullagar and Kitto JJ pointed out in *Box* (cited with approval by the majority in *Murry*), '[g]oodwill includes whatever adds value to the business, and different businesses derive their value from different considerations'.[368] What is of most significance in determining if goodwill exists is proof that the business generates earnings and will continue to generate earnings if it continues to be conducted in substantially the same manner and by substantially the same means.[369]

Before his Honour went on to consider these arguments, he set out the fundamental propositions for which he considered *Murry* to be authority:

(a) Goodwill is an asset that is legally distinct from its sources.

(b) The existence of goodwill depends upon proof that the business generates, and is likely to continue to generate, earnings from the use of the identifiable assets, locations, people, efficiencies, systems processes and techniques of the business.

(c) It is every positive advantage that has been acquired by the old firm in carrying on its business.

(d) The concept of goodwill recognises that, used in an established business that attracts custom, the tangibles may be expected to earn in the future as they have earned in the past.

(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.

(f) The sources of goodwill may include manufacturing and distribution techniques, the efficient use of the assets of a business, superior management practices or good industrial relations.

(g) Goodwill is the legal right 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 and generated earnings.

(h) The value of goodwill of a business is tied to the fortunes of the business. It varies with the earning capacity of the business and the value of other identifiable assets and liabilities.

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367 *Murry* (1998) 93 CLR 605, 611 [12].
368 Ibid; *Alcan 2* (2008) 24 NTLR 33, 73-4 [134].
369 *Alcan 2* (2008) 24 NTLR 33, 74 [135]. See above n 77 in relation to the more expansive meaning of the term 'earnings' in the relevant part of the majority's reasons.

(i) When a business is profitable and expected to continue to be profitable, the value of goodwill 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 the identifiable net assets. In a profitable business the value of the goodwill for legal and accounting purposes will often be identical.[370]

In considering the parties' arguments in light of his understanding of the law, Southwood J found that it was self-evident that the Gove joint venture business, which had been a going concern and had sold very substantial quantities of alumina and bauxite profitably for 30 years or more, had an attractive force that brought in custom.[371] Further, GAL had combined and used the tangible, intangible and human assets of the business in such a way that custom had been drawn to it. The business's attractive force was also evidenced by the fact that at the time of the sale of GAL's shares or shortly prior to the sale of its shares, most of its alumina was committed under long term contracts which were described as competitive and profitable. Not only did this demonstrate loyalty on the part of its relevant customer or customers, but it recognised there was a demand for GAL's alumina by other consumers of the product.[372]

Also, although GAL was part of a vertically integrated business, it did not simply operate as a division of CSR. Nor did it refine alumina for a fee or operate just to recover costs. Rather it was a business which operated for profit.[373]

Although the issues in the present case primarily concerned the *existence* and *value* of goodwill, Justice Southwood went on to give his opinion about how one should determine the *nature* of goodwill in any given case. He said to do so it is necessary to consider the type of business and the type of customer which such a business is inherently likely to attract as well as all the surrounding circumstances.[374] In considering those factors, his Honour made a number of findings of fact about the market for alumina at the time that Alcan purchased the shares in GAL, and the likely sources of an alumina company's 'attractive force which brings in custom'.

He observed that the characteristics of the alumina market included:

(a) the fact that alumina is a specialised intermediate product used in the production of aluminium;

(b) a concentrated number of large aluminium smelters, the owners of which were the main consumers of alumina;

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[370] Ibid 74 [136]-[137].
[371] Ibid 74-5 [138].
[372] Ibid 75 [138].
[373] Ibid 75 [139].
[374] *Federal Commissioner of Taxation v Williamson* (1943) 67 CLR 561, 564 (Rich J).

(c) a concentrated number of large refineries, the owners of which were the main producers of alumina;

(d) vertical integration of bauxite mines and alumina refineries;

(e) relatively scarce refinery capacity;

(f) barriers to entry, which were created in part by the large costs involved in establishing an alumina refinery;

(g) long term supply contracts; and

(h) relatively price inelastic demand.[375]

In those circumstances, the sources of any attractive force which brings in custom to a supplier of alumina were likely to have included:

(a) the size of the refinery;

(b) access to a cheap and substantial supply of bauxite;

(c) location;

(d) accessibility;

(e) refining capacity (over the short term, medium term and longer term);

(f) reliability, consistency, quality (sandy alumina as opposed to floury alumina);

(g) the ability to supply the alumina at or competitively with the World price of alumina;

(h) ability to negotiate long term supply contracts; and

(i) connections with the established large aluminium smelters.[376]

His Honour found that the evidence established that GAL had significant advantages in all of these areas and that there was no dispute that they added value to its business.[377]

There was also no dispute that the advantageous circumstances identified by Mr Bryant existed and added value to the business. In his Honour's opinion, these were all factors which ‘positively affected’ the sources of GAL's attractive force that brings in custom which the judge had previously identified.[378] These advantages or advantageous circumstances did not inhere in the tangible assets of the business. Rather, his Honour found that they arose because of a number of factors. First,

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375 *Alcan 2* (2008) 24 NTLR 33, 75 [140].
376 Ibid.
377 Ibid.
378 Ibid 75-6 [141].

they arose as a result of the efficient use of a combination of assets which in turn was facilitated by the continuity of the business and the other favourable connections of GAL including the quality of management, the technical skills and expertise of management, a skilled workforce, good industrial relations, past and existing cash flows and the capital raising ability of the joint venture. Second, the advantageous circumstances arose because of the geographical location of the bauxite mine and the refinery, the configuration of the plant and the equipment, economies of scale and the synergy between the operation of the bauxite mine and the operation of the refinery.[379]

In Justice Southwood's view, what followed from all of the above was that GAL operated a business that had goodwill and that the sources of goodwill added value to that business.[380] As a result, his Honour ordered that the matter be remitted to the Commissioner to enable the value of the goodwill to be determined in accordance with the principles applicable to a profitable business enunciated by the High Court in *Murry*.[381]

VIII. ORIGIN ENERGY IN THE STATE ADMINISTRATIVE TRIBUNAL OF WESTERN AUSTRALIA

Within months of *Alcan 1* being delivered, but before the Northern Territory Court of Appeal delivered its reasons in *Alcan 2*, President Barker of the State Administrative Tribunal (WA) delivered his reasons in *Origin Energy.*

A. Background

In *Origin Energy*, the applicant, Origin Energy Pty Ltd ('Origin'), acquired all the shares in Fletcher Challenge SouthWest Cogeneration Ltd ('FCSWCG'), which held a 50% interest in the South-Western Cogeneration Joint Venture ('SWCJV'). The joint venture owned and operated a co-generation facility which produced electricity and steam. The facility was located on Crown land leased to the participants in the Worsley Alumina Joint Venture ('WAPLJV'). The WAPLJV subleased the land on which the cogeneration plant was located to Western Power ('Site Lease') who granted a licence to the participants in the SWCJV to occupy the land ('Site Licence'). Natural gas was supplied to the plant under a gas services agreement and was delivered via the Dampier to Bunbury natural gas pipeline. A spur line built by the SWCJV supplied gas to the cogeneration facility's gas turbine.

All of the output of the cogeneration facility was the subject of forward sales contracts in the form of a Master Energy Agreement ('MEA') by which electricity and steam was sold to the WAPLJV, and a Power Purchase Agreement ('PPA') by which electricity was sold to Western Power. Under the MEA, operation and first line maintenance of the plant was undertaken by Worsley employees at no

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379 Ibid 76 [142].
380 Ibid [143].
381 Ibid 74 [137],76 [143].

cost to the SWCJV. Long term maintenance was contracted under a maintenance agreement to GEC Alsthom for the first major maintenance cycle, which was approximately six years. Both the MEA and the PPA were entered into in June 1999, more than a year before the plant was commissioned and 3 years before the shares were transferred to Origin on 28 June 2002.

The Commissioner of State Revenue imposed stamp duty on the sale of the shares on the grounds that 80% or more of the property to which FCSWCG was entitled was 'land'[382] within Western Australia. The Commissioner also imposed penalty tax of 100% of the primary duty. Origin appealed to the SAT.

B. The arguments

There were several grounds of appeal, but for present purposes the relevant ground was that FCSWCG was entitled to property in the form of goodwill, valued by Origin at between $26 million and $32 million. Origin submitted that this goodwill was to be found in the amount the purchase price it paid for the company exceeded the tangible assets of the company. The Commissioner submitted that the difference in value was attributable to the suite of contracts to which the company was a party, and which were expressly excluded from being included in a calculation of the company's property by section 76AP(3) of the (now repealed) *Stamp Act* 1921 (WA). In any event, FCSWCG had no entitlement to goodwill of any value.

Origin contended that where all of the custom or business occurs by reason of a limited number of executory sales contracts, it is necessary to determine the value of the sales contracts and the assets used to service the sales contracts. The value of the business over and above the value of the sales contracts and the necessary assets represents the value of goodwill.[383]

Origin argued that the basic assumption underlying the Commissioner's calculation of goodwill was that the value of a business is equal to the value of its main assets. It said that this was incorrect and failed to consider whether the assets are themselves a source of goodwill. In the present case, the sales contracts were struck at market rates and had little or no market value without the Site Licence and in isolation from the joint venture.[384] However, they were sources of goodwill as they both attracted and guaranteed future custom.[385]

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[382] 'Land' was defined in section 76 of the *Stamp Act* 1921 (WA) to include estates and interests in land and anything fixed to the land including anything that is, or purports to be, the subject of an entitlement separate from the ownership of the land. However, on 15 December 2010, in *TEC Desert Pty Ltd v Commissioner of State Revenue* [2010] HCA 49, the High Court of Australia reversed a 3-0 decision of the Western Australian Court of Appeal, holding unanimously that an interest in a Western Australian statutory mining lease or other tenement does not amount to an interest in land but is in the nature of a personal interest only. Consequently, mining plant fixed to the land the subject of the tenement, the attachment and removal of which is the subject of specific statutory provisions, does not become a fixture at law. Subsequently, the State of Western Australia (retrospectively) amended the *Duties Act 2008* (WA) to deem fixtures on mining tenements (if the mining tenement was freehold land) as well as certain pipelines to be land.

[383] *Origin Energy* (2007) 70 ATR 64, 76 [88].

[384] Ibid 76 [90]-[91].

[385] Ibid 104 [294].

Origin relied on the evidence of two expert accountants, Mr Edwards and Mr Reid. In Mr Edwards' view, goodwill arose from combined used of the assets of the SWCJV including:

(a) the leasehold estate on which the cogeneration plant is located;

(b) plant and equipment constituting the cogeneration plant;

(c) management skills;

(d) technical skills; and

(e) inward and outward supply contracts.[386]

Depending upon which unit price for electricity is used, the value of the goodwill amounted to between $26.5 and $31.7 million or between $32.8 million and $37 million.[387]

Mr Reid also considered that there was significant goodwill in the SWCJV business. He identified the sources of that goodwill as:

(a) the potential for the co-generation facility to generate value beyond the existing 15 year contract period;

(b) the potential for the operators of the co-generation facility to generate improved operational performance compared with that estimated in the MEA project model;

(c) the combination of contracts that together enable the SWCJV to operate and reduce the risk associated with its business;

(d) significant entry and exit costs that characterise cogeneration gas plants make duplication of existing assets unlikely;

(e) compensation for the risks associated with constructing a co-generation plant;

(f) a potential purchaser and may be willing to pay a premium for assets which provide the purchaser with diversity of geography, regulatory requirements or energy type - a portfolio premium; and

(g) the assets may be able to generate returns in excess of those set out in the MEA project model.[388]

Like Mr Edwards, Mr Reid valued goodwill as the residual after the fair market value of identifiable tangible and intangible assets had been deducted from the purchase price paid for the shares,

386 Ibid 91 [193].
387 Ibid 92 [199]-[203].
388 Ibid 94 [218].

although on Mr Reid's calculations, FCSWCG was entitled to goodwill in the amount of $26 million.[389]

Origin contended that its experts' approach to the calculation of goodwill was correct in that it:

(a) calculated the net present value of predicted cash flows from the business of FCSWCG; and

(b) deducted from this value the value of the co-generation facility to reach the residual value for goodwill.

On this basis the value of FCSWCGG's goodwill was in the range of $26.5-$31.7 million.[390] Origin sought to distinguish *Alcan 1* on the ground that the distinction between inherent contractual value and the value of an executory contract in guaranteeing custom had not been drawn in the evidence or in submissions made to Mildren J.[391]

The Commissioner claimed that the approach taken by Origin was wrong because it illogically and arbitrarily attributed little or no value to the sales contracts and attributed all the value in the business to plant and equipment and to goodwill. The Commissioner said that the net present value of predicted cash-flows from the company's business necessarily arose from both the cogeneration plant and the sales contracts. The Commissioner relied on *Murry*[392] for his claim that the earning power of the business did not exceed the earning power of the co-generation plant and the sales contracts, and therefore all of the value of the business was in the plant and the sales contracts.[393]

The Commissioner also relied on the evidence of an expert accountant, Mr Churchill, who had been asked by the Commissioner to comment on the reports of the other experts concerning the existence of goodwill in the context of guidance provided by Mildren J in *Alcan 1*. Although not a lawyer, Mr Churchill gave evidence that he understood Mildren J to have found that goodwill describes attributes that attract custom and that if no such attributes could be identified, goodwill did not exist. Mr Churchill expressed the view that, having given consideration to the existence of 'customer-attracting attributes' of the SWCJV, he could not identify any. He formed the view that it is unlikely that any goodwill existed in the SWCJV or FCSWCG as of the date of Origin's acquisition of FCSWCG and that any intangible asset was likely to be represented by the suite of contracts as scheduled in the share sale agreement.[394]

In his evidence, Mr Churchill made a number of statements which demonstrated his firm attachment to a patronage approach to goodwill. For example, when it was suggested to him that at the time of

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389 Ibid.
390 Ibid 76 [92].
391 Ibid 103 [289].
392 *Murry* (1998) 193 CLR 605, 625 [51].
393 *Origin Energy* (2007) 70 ATR 64, 78 [106].
394 Ibid 94-95 [219]-[220].

the transfer of the shares the co-generation facility was no longer a mere start-up operation, Mr Churchill conceded that this was so but responded that

> [No-one] has created a business, in the sense that one had gone knocking on doors and sent flyers out, and through a marketing campaign attracted customers, and trained people on how to produce steam and electricity, but rather the cash-flows were merely manifesting what was expected from the modelling.[395]

Mr Churchill went on to cite the following matters in support of his contention that neither FCSWCG nor the SWCJV had any goodwill:

(a) the SWCJV was established primarily to respond to a permanent increase in electricity demand from the WAPLJV consequent to the expansion of the WAPJV's production;

(b) the proximity of the SWCJV to the WAPLJV (essentially contained within the Refinery) provided the SWCJV with a competitive advantage for the supply of electricity and thermal energy (transmission losses are almost eliminated);

(c) two customers had purchased all the available capacity from the SWCJV since commissioning and would continue to do so for the life of the MEA and PPA;

(d) without the MEA, Site Lease, Site Licence and Site Services Agreement, it was unlikely that the plant could exist at the Refinery and generate the revenues available under the MEA; and

(e) the output of the SWCJV is a homogenous product which is indistinguishable from the product available from Western Power (noting, however, that there appears to be no other source of thermal energy in close proximity).[396]

Mr Churchill noted that in *Alcan 1,* Mildren J considered that the location of the business could be a source of goodwill. In this instance, however, he considered that the location of the SCWJV plant was consequent upon a legal agreement between the WAPLJV and the SWCJV.[397] If the location was a source of competitive advantage resulting in cash flows to the SWCJV (possibly a significant advantage when considering the value of the thermal energy purchased by the WAPLJV), he considered that the value should be attributed to the Site Lease.[398]

Mr Churchill considered that the net cash flows generated by the SWCJV (and expected to be generated as at the valuation date) arose largely as a consequence of a number of apparently critical legal agreements which addressed:

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395 Ibid 100 [263].

396 Ibid 96 [231].

397 This is not a distinguishing feature as in *Alcan 1* location was also dependent upon legal agreements in the form of leases granted to Alcan by the Northern Territory government.

398 Ibid 96 [232].

(a) the ability to operate a generating facility (the Site Licence);

(b) the ability to deliver thermal energy and electricity energy with limited transmission loss (the Site Lease);

(c) maintenance (the MEA);

(d) revenue (100% capacity is sold via the MEA and PPA); and

(e) fuel (100% of the gas necessary to operate the plant is purchased pursuant to the GSA and pipeline access agreement).

In these circumstances, Mr Churchill said that he was unable to identify any source of goodwill at the valuation date.[399]

C. The findings

Like Justice Mildren in *Alcan 1*, President Barker found considerable force in the Commissioner's submissions concerning goodwill saying that it seemed to him that the approach taken by Origin's experts to the identification of a goodwill value was ultimately dependent on usual accounting approaches without real regard to whether there was an attractive force which brings in custom and adds to the value of the business.[400] He considered that the identification by those experts of factors such as location and efficiency of operation to explain the goodwill value they had calculated did not stand up very well in the face of the critique provided on behalf of the Commissioner which he said strongly suggested that the bulk of the purchase price paid for the shares in FCSWCGG could be accounted for by the rates payable for electricity and thermal energy under the sales contracts.[401]

President Barker acknowledged Origin's argument that the relevant custom was present and guaranteed by the executory supply contracts but found that the attractive force that brings in custom and adds to the value of the business comprehended by the majority in *Murry*, needed to be explained by one or the other or a variety of the sources of goodwill identified by the majority in *Murry*.[402] He named these as including:

(a) location, at [24], [26];

(b) the way in which the business is conducted, at [24];

(c) the personality of those who conduct it, at [24];

(d) the likelihood of competition, at [24], [26];

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399 Ibid 96 [233]-[234].
400 Ibid 104 [293].
401 Ibid.
402 Ibid 104 [294].

(e) manufacturing and distribution techniques, at [25];

(f) efficient use of the assets of the business, at [25];

(g) superior management practices, at [25];

(h) good industrial relations, at [25]; and

(i) the product of expenditures rather than use of assets, at [27]. [403]

He said one could not simply point to the particular obligation of the purchaser to pay a vendor guaranteed rates for a product under a supply contract that had brought the business in question into existence.[404]

President Barker accepted the opinion of the Commissioner's expert that without the suite of contracts, the business of FCSWCG would in effect be worthless. In contrast, he found that the contracts were identifiable assets which existed before FCSWCG commenced its business as part of the SWCJV.[405] Their value reflected the profits that could be earned from contracts on a DCF basis. Importantly, he found that Origin attached a value to the contracts before the business even commenced, by purchasing its share of the future business enterprise.[406] The supply contracts, like the taxi licence in *Murry*, provided a very high level of comfort to the purchaser. In simply starting the business by building the cogeneration facility, a profit would be made. There was no evidence that the building of the co-generation facility was a particularly risky commercial venture.[407]

President Barker found that the actual decision in *Murry* was applicable. He said that although the majority had found that the taxi licence authorised the lawful conduct of the business, it did not attract custom. It was the actual operation of the taxi business that attracted custom. Such a conclusion was demonstrated by the fact that the licence had value before the taxi business commenced. That value would no doubt reflect the profits that could be earned conducting a business that the licence authorised. Yet until there was a business there can be no goodwill.[408] In the President's view, like the taxi licence in *Murry*, the sales contracts existed and had value at a time before the business commenced and so could not be sources of goodwill.

Furthermore, even after the SWCJV commenced business there was still likely to be little, if any, goodwill generated because there was no opportunity for the business to attract *further* custom. This was because all electricity and steam from the co-generation facility was contracted for, there

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403 Ibid 101 [272].
404 Ibid.
405 Ibid 105 [298].
406 Ibid 105 [299]. This is factually incorrect as although Origin made a bid for the shares in June 2000, it did not contact to purchase them until June 2001 and did not actually acquire them for stamp duty purposes until June 2002. On any view, the SWCJV business had commenced well before June 2002.
407 Ibid 105 [300].
408 Ibid 105 [299].

was no spot market for electricity, and steam by its nature could not be sold into any market.[409] In the President's opinion, a business which had no opportunity or ability to attract further custom could not have goodwill.

In summary, President's reasons for finding that FCSWCG had no goodwill were as follows:

(a) to constitute legal goodwill in the form of an 'attractive force which brings in custom', a business's goodwill must be explained by one or more of the sources of goodwill identified by the High Court in *Murry*;

(b) the sales contracts could not be sources of goodwill because they existed and had value at a time prior to the business commencing;

(c) the entire earning power of the SWCJV business (future or present) was attributable to the sales contracts leaving no room for goodwill;

(d) no business was in existence when Origin made its bid for the shares in FCSWCGG and so no part of the purchase price could have been paid for goodwill; and

(e) even after business commenced, it had no attractive force which brings in custom because it sold all of its product under contract and had no capacity or ability to attract further custom.

D. Analysis

Each of President Barker's findings requires careful analysis.

1. To constitute legal goodwill in the form of an 'attractive force which brings in custom', a business's goodwill must be explained by one or more of the sources of goodwill identified by the High Court in *Murry*

There are numerous difficulties with this finding. First, although the President lists several of the sources of goodwill identified by the High Court in *Murry*, he omits more than he includes.[410] Second, at least two of the sources on President Barker's abbreviated list - location and efficiency of operation - were actually claimed by Origin to be present in the joint venture business,[411] while a third, identifiable assets (in the form of sales contracts) was specifically identified by the High Court as being a potential source of goodwill.[412] Third, even the numerous sources of goodwill identified by the High Court were expressed by them to be 'typical' or potential sources of goodwill such that the list was never intended to be exhaustive. One of the reasons for this is because, as the majority acknowledged, 'goodwill includes whatever adds value to a business, and different businesses

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409 Ibid 105 [301].

410 Cf President Barker's list of sources of goodwill at 101 [272] with those identified by the majority in *Murry* (1998) 193 CLR 605, 611 [12], 615-17 [24]-[28].

411 *Origin Energy* (2007) 70 ATR 64, 104 [293]-[294].

412 *Murry* (1998) 193 CLR 605, 611 [12].

derive their value from different considerations'.[413] Another is that businesses are always changing making it impossible to exhaustively identify their sources of value for all time. For example, today's social networking businesses did not even exist in 1998 such that their unique sources of value were not even within the High Court's contemplation when it delivered judgment in *Murry*.

2. The sales contracts existed and had value at a time prior to the business commencing and as such could not be sources of goodwill

In finding that the sales contracts were not sources of goodwill, the President placed great importance on the fact that the contracts existed and had value prior to the business itself existing. Putting aside for a moment whether in fact a business was in existence at the time one or more of the sales contracts were entered into, nothing in *Murry* supports the proposition that because an asset came into existence or was acquired before a business comes into operation, it cannot subsequently qualify as a source of goodwill for the business after it commences operating. Any asset, regardless of when it comes into existence or is acquired, may be a source of goodwill in an operating business if alone or working together with the other assets of the business it produces earnings or adds value. In the case of the sales contracts, they had value *only* in the context of the SWCJV business, and *only* in conjunction with its other assets. President Barker appears to acknowledge this when he says, rather curiously, '[t]he applicant attached a value to the contracts before the business even commenced, *by purchasing its share of the business*'.[414] (emphasis added) In any event, without either the joint venture business or its assets, the contracting party would not be able to perform its obligations such that the contracts would likely amount to a liability in its hands rather than an asset.

Similarly, the fact that an asset has independent value does not disqualify it from being a source of goodwill although it is true that a purchaser will not pay twice for that asset; once in its own right and again as a source of goodwill in a business. It is for this reason that the goodwill of a business is usually measured as the difference between the value of the business as a going concern, and the value of its identifiable assets.[415]

3. The entire earning power of the SWCJV business (future or present) was attributable to the sales contracts leaving no room for goodwill

In *Murry*, the majority observed that even where an asset has independent earning power, that earning power is unlikely to equal the earning power of the business such that if the asset is sold, the goodwill of the business disappears.[416]

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413 Ibid citing Dixon CJ, Williams, Fullagar and Kitto JJ in *Box* (1952) 86 CLR 387, 397; See also [17].
414 *Origin Energy* (2007) 70 ATR 64,105 [300].
415 *Murry* (1998) 193 CLR 605, 624 [49].
416 Ibid 625 [51]. Presumably the goodwill would disappear as without the asset the business would no longer have the ability to generate revenue and would cease to operate.

In the present case, President Barker was prepared to accept that the entire earning power of the business (future or present) was attributable to the sales contracts, even though the SWCJV was incapable of performing the contracts or generating any income from them in the absence of the other assets of the business. It was for this reason that Origin's experts argued that isolated from the business, the contracts themselves were of little or no market value, although as a source of goodwill for the business, they contributed substantial value because they represented a guaranteed cash flow for the business.

In ascribing the significant value to the contracts that he did, President Barker fell into the same error as Justice Mildren of failing to exclude from that value the future economic benefits or income streams attributable to other assets, as well as the value of the synergistic benefits that might result through the combination of the contracts with the other assets of the business. In addition, and like Justice Mildren, he also failed to apply the correct legal test of value as set out in *Spencer* and allowed the contracts to be valued at their value in use, or value to the SWCJV, rather than at their market value or value in exchange to hypothetical purchasers.

4. No business was in existence when Origin made its bid for the shares in FCSWCG and so no part of the purchase price could have been paid for goodwill

As goodwill is inseparable from the conduct of a business, goodwill can only exist if an operating business exists. It was common ground between the parties in *Origin Energy* that the relevant date to determine the entitlement of Origin to land and other property, including goodwill, was the date the shares in FCSWCG were transferred to Origin on 28 June 2002. Clearly by this time the SWCJV was operating a business which was generating substantial revenue and making significant profits and by acquiring the shares in FCSWCG, Origin acquired a share in this business and in any goodwill of that business. However, President Barker was persuaded by the Commissioner's expert that financial modelling indicated that Origin's proposal to acquire the FCSWCG interest in the SWCJV, and its pricing of the interest, took place in June 2000, some four months before the plant had been commissioned or started up. Consequently, he found that Origin had attached a value to the sales contracts prior to any business commencing and so prior to the possibility of any goodwill existing. For this reason no part of the purchase price of the shares (which all accepted represented the total property to which Origin was entitled) was attributable to goodwill.

To the extent that President Barker relied on the timing of Origin's original proposal, that reliance was misplaced given that the legislation required that the value of Origin's entitlement to property be assessed at the date it was entered on the register of members of FCSWCG on 28 June 2002 and not at some earlier time.[417] However, even if the date of its original proposal was relevant to the inquiry, it does not follow that no part of the purchase price of the shares was attributable to goodwill. This is because whether or not FCSWCG was conducting a business at the time Origin

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417 *Affinity Health Ltd v Chief Commissioner of State Revenue* [2005] NSWSC 663.

contracted to acquire its shares in June 2000, the purchase was conditional such that Origin was not required to complete the transaction and pay for the shares until after the plant had been constructed, commissioned and started up. The purchase price for the shares was therefore intended to reflect the value of the future going concern business, and so had built into it the costs, risks and delays associated with that construction, commissioning and starting up, together with a developer's profit. On this basis it is very likely that part of the purchase price was referrable to the goodwill of the future operating business.

When Origin contracted to purchase the shares in June 2000, it acquired the right to utilise all of the assets and attributes of the started up business to produce income without interruption despite the change of ownership. Origin thereby avoided incurring the costs, risks and delay in the receipt of revenue associated with starting up a co-generation business from scratch. Origin did not argue its case in this way, nor did it seek to value the goodwill it acquired by purchasing the shares in FCSWCG by attempting to quantify the value of these costs, risks and delays. For these reasons it was never put to President Barker that the purchase price included the value of these foregone costs, risks and delays and that if quantified, these represented a reasonable estimate of the goodwill of the going business which Origin actually acquired in June 2002. Rather, because it was able to value the identifiable assets of the business with precision, Origin estimated the value of the goodwill by the usual accounting method of finding the difference between the net present value of the business (by reference to the purchase price it paid for the shares) and the value of its identifiable assets. This amounted to between $26.5 and $37 million. While such a methodology was clearly open to it,[418] Origin fell at the first hurdle when it was unable to convince the learned President that the purchase price of the shares agreed in June 2000 reflected the value of the operating co-generation business rather than the value of a collection of assets absent a business.

5. The SWCJV had no 'attractive force which brings in custom' because it sold all of its product under contract and had no capacity or ability to attract further custom

The final reason why President Barker found that FCSWCG had no entitlement to property in form of goodwill was because he considered that the SWCJV had neither the capacity nor the ability to attract further custom to its business. In reaching this conclusion, President Barker adopted Justice Mildren's patronage approach to goodwill but with a gloss. While Mildren J required that a business have custom from *multiple unrelated* customers in order to have an 'attractive force', Barker P added a further condition which had been suggested to him by the Commissioner's expert. This was that a business must also demonstrate that it had the capacity and will to supply additional goods or services and so attract *further* custom. If all of the output of the business was committed to *existing* customers, whether singular or plural, related or unrelated, no further custom could be

[418] *Murry* (1998) 193 CLR 605, 614 [20].

brought in and so no legal goodwill could exist. President Barker found that such was the case in the SWCJV.[419]

If President Barker's analysis is correct, legal recognition of goodwill would be denied to that most successful of businesses i.e. the business which through marketing, service, product differentiation or some other means manages to sell all of the goods and services which it produces. It may also deny legal recognition to the goodwill of any business operating in a market in which demand simply exceeds supply. This exposes another flaw in President Barker's narrow construction of the *Murry* doctrine of goodwill; i.e. that even on a patronage approach to goodwill, maintaining existing custom is as much a display of a business's attractive force as securing new or further custom.

Because Barker P found that the co-generation business had no goodwill, he accepted the Commissioner's argument that the difference between the price paid for the shares and the value of the plant was attributable to the suite of contracts and in particular the MEA and the PPA. This is despite evidence that if the sales contracts were terminated, new contracts could quite easily be renegotiated with the same parties on equivalent or only slightly less favourable terms.[420] While it does not necessarily follow that the contracts had no market value (one of Origin's valuers valued them at $4 million), it is questionable whether their value could amount to half of the amount paid for an interest in the joint venture.

Like Mildren J in *Alcan 1*, having decided that the acquired business had no goodwill, Barker P had to account for the excess value which was clearly present in the business and for which the taxpayer in *Origin Energy* had paid approximately $32 million. While Justice Mildren allocated this excess value to the business's identifiable *tangible* assets, primarily its fixed plant and equipment, President Barker allocated it to the business's identifiable *intangible* assets, primarily its sales contracts, even though it was evident that those assets could not generate the predicted earnings or cash flow on their own. Fortunately for Origin, President Barker's finding that its interest in the fixed plant and equipment did not give the joint venturers an equitable interest in land saved FCSWCG from being found to be land rich. As such, Origin succeeded in its appeal.

IX. GOODWILL, GOING VALUE AND GOING CONCERN VALUE

A. Distinctions and differences

The reasons of Mildren J in *Alcan 1,* Barker P in *Origin Energy,* and Martin CJ and Southwood J in *Alcan 2,* disclose theories of goodwill which are to a greater or lesser extent, patronage based; while Angel J favoured the broader 'added value' approach. For Mildren J and Martin CJ, goodwill is a narrow concept rooted in the ability of a business to repeatedly attract a variety of unrelated customers to purchase its product or service. Barker P would add to this additional two

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419 *Origin Energy* (2007) 70 ATR 64, 105 [301].
420 Ibid 94 [217], 98 [246].

requirements i.e. that the business have the capacity to attract further such custom, and that the sources of attraction be among those identified by the High Court in *Murry*. In addition, all three judges considered that in order for legal goodwill to exist, the product or service on offer must not be of a homogenous or commodity kind. Even without President Barker's additional requirements, on this theory, goodwill is present in a business for legal purposes only if it sells a certain kind of product or service to certain kinds of customers who are directly attracted to the business on account of certain of its attributes.

While Mildren J did not expressly define goodwill by reference to any legal right or privilege, both Martin CJ and Barker P[421] accepted that goodwill as property could be described in terms of the legal rights and privileges enjoyed by the proprietor of a business.[422] However, neither judge recognised that as the relevant taxpayer in the case before him had acquired those rights and privileges when it acquired the relevant business, it necessarily followed that the taxpayer had also acquired the goodwill of the business.[423] With respect to their Honours, this failure, coupled with a misconceived focus on the identity and number of the business's customers and the type of product sold, led them into error and put them in direct conflict with the majority in *Murry*.

Both Angel and Southwood JJ rejected this approach and instead focused on the concept of goodwill as the relevant proprietary rights and privileges identified by the High Court. Unlike their colleagues, they accepted that the taxpayers had acquired those rights and privileges when they acquired a share in the relevant joint venture business, and as such, had also acquired goodwill in a legal sense.[424]

While both judges acknowledged the importance of custom, they also recognised that a business which is operating and generating revenue necessarily has that custom and that the identity of its customers and the nature of its product or service is irrelevant to the question of whether the business has goodwill for legal purposes.[425] They also accepted that where the business is profitable, the value of that goodwill can be obtained by the conventional accounting approach of measuring the excess of value between the business and its identifiable assets.[426]

However, where the judges parted ways was that Justice Angel found it unnecessary to search for some sort of causal connection between the alleged sources of goodwill of GAL's bauxite and alumina business, and custom being attracted to the business. In his view, it was plain enough that the business had ongoing custom and would continue to enjoy that custom in the future.[427] The

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421 *Alcan 2* (2008) 24 NTLR 33, 61 [81], 62 [83] (Martin CJ); *Origin Energy* (2007) 70 ATR 64, 101 [271] (Barker P).
422 These are recited in *Murry* (1998) 193 CLR 605, 615 [23].
423 *Murry* (1998) 193 CLR 605, 623 [45].
424 *Alcan 2* (2008) 24 NTLR 33, 69 [114] (Angel J), 72-3 [132] (Southwood J).
425 Ibid 68-69 [112], [115] (Angel J), 74-75 [138] (Southwood J).
426 Ibid 69-70 [116]-[117] (Angel J), 74 [137], 76 [143] (Southwood J).
427 Ibid 69 [115].

absence in his judgment of an inquiry into the sources of goodwill of the Gove business suggests that he did not consider that the matter required it.

In contrast, Justice Southwood did conduct such an inquiry. He considered that only the attributes of a business which added value to it by maintaining or increasing custom either directly or indirectly could be sources of goodwill for legal purposes. Other benefits or advantages which arose from the continuity of the business and added value to it without necessarily maintaining or increasing custom could not. He referred to these other benefits or advantages as 'going value' and identified them as including:[428]

(a) good relations with suppliers of the business;

(b) good industrial relations;

(c) the quality of management;

(d) the configuration of plant and equipment;

(e) the technical skills of management and senior staff;

(f) technological skills;

(g) credit management; and

(h) capital raising ability.[429]

In *Alcan 2*, Justice Southwood found that the Gove business had both the customer attracting attributes necessary for legal goodwill to exist, as well as some of the other benefits or advantages, which while not sources of goodwill in themselves, did have a positive effect on the business's customer attracting attributes which were.[430] For this reason, he did not find it necessary to address the additional source of value represented by these non-customer attracting attributes, although he did wonder whether this 'going value' might be another form of parasitic incorporeal property which might be obtained by acquiring the right to conduct a business in substantially the same manner and by substantially the same means.[431]

B. 'Going value'

While Justice Southwood described 'going value' in terms of 'the benefits or positive advantages which arise from the continuity of organisation of a going business, but which may not necessarily increase or maintain custom',[432] he recognised that in the United States, 'going value' (also called

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428 Ibid 73 [133].
429 Ibid 73 [133].
430 Ibid 75-76 [140]-[141].
431 Ibid.
432 Ibid.

'going concern value') is defined more expansively to include all of the advantages that an operating business enjoys over a non-operating or start-up business.[433] These advantages arise and add value to a going business because its acquirer receives a business with all assets assembled and in place and earning income while an acquirer of the non-operating or start-up business can only enjoy those benefits after he or she incurs substantial start-up costs, suffers a delay in the receipt of revenue, and assumes the risks inherent in starting up and ramping up a new business.

West's Encyclopaedia of American Law puts it this way:

> As a component of business value, going concern value recognizes the many advantages that an existing business has over a new business, such as avoidance of start-up costs and improved operating efficiency. In this sense, the going concern value of a firm represents the difference between the value of an established firm and the value of a start-up firm.[434]

In *Concord Control Inc. v. Commissioner,*[435] the Tax Court stated that the features of the taxpayer's operating business that produced going-concern value included that the ongoing business was earning money, and that it possessed a trained staff of employees, a line of products ready for sale, and equipment ready for immediate use.[436]

Typically, going concern value is treated by US judges and commentators as property in its own right, separate from goodwill; although as one commentator observes, '[e]ven the courts, while repeatedly insisting that the two terms represent entirely discrete concepts, have frequently failed to offer a reasoned explication of the perceived difference'.[437] Other commentators ask whether going concern value is a separate intangible or really just an element of or even synonymous with goodwill.[438]

In his 1988 article, 'Excess Earnings, Competitive Advantage and Goodwill', Glenn M Gomes defines both going concern value and goodwill in terms of distinct but separate economic advantages, describing the former as 'savings based' and the latter as 'earnings based'.[439]

> It might be argued that all businesses that are capable of surviving in a competitive economic environment possess some amount of goodwill. In the absence of actual (or potential) excess earnings resulting from a competitive advantage, however, any price premium paid for a business that

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433 Ibid footnote 61. In the United States, the term 'going concern value' is also used by appraisers to describe 'the value of a proven property operation', i.e. the overall value of an operating business, including its tangible and intangible assets. See The Appraisal Institute, *The Appraisal of Real Estate*, (11th ed, 1996) 26. It is not used in this alternative sense in this thesis.

434 Jeffrey Lehman and Shirelle Phelps (eds), *West's Encyclopaedia of American Law* (Thompson Gale, 2nd ed, 2008).

435 35 TCM (CCH) 1345, 1357 (1976).

436 In *Concord Control Inc v Commissioner* 68 TC 563 (1977). Although the Sixth Circuit disallowed an appeal against the Tax Court's decision, it remanded the matter back to the Tax Court to explain the method by which it came to allocate 20% of the purchase price of the business to going concern value.

437 Editors' Comment, Depreciability of Going Concern Value, (1973) 122(2) *University of Pennsylvania Law Review* 484-497.

438 See the discussion in Hilton M Wiener 'Going Concern Value: Goodwill by Any Other Name?' (1979-1980) 33 *Tax Lawyer* 183.

439 (1988) 26(3) JSBM 22, 29.

exceeds the value of the firm's tangible assets reflects ‘going concern value’ rather than goodwill.[440] Going concern value, in contrast to goodwill value, represents the incremental value of the firm's assets that accrues as a result of the configuration of those assets into a productive operating system. Moreover, it represents the firm's ability to continue to generate uninterrupted revenues despite a change in ownership.[441]

> From a prospective purchaser's point of view, going concern value reflects the avoidance of start-up costs, and the benefits of operating, marketing, and administrative efficiencies that may have developed through organizational learning and experience. All things being equal, an established business is likely to be more profitable than a newly formed enterprise. The presence of going concern value does not necessarily imply the existence of excess earnings, but only a level of earnings that exceeds the earnings of firms new to the industry. Going concern value inheres in the presence of property, plant, equipment, and other productive assets that are configured into a system that is up-and-running. Goodwill, on the other hand, is associated with the incremental value created by the existence, continuation, or expectation of excess earnings over and above the normal rate of return for the industry as a whole. Going concern value is thus ‘savings’-oriented, and goodwill value is earnings-oriented.

The US Master Bank Tax Guide draws a different distinction between goodwill and going concern value. It describes the former in terms of favourable customer relations and the latter as ‘the value that is attributable to the firm’s ability to continue to function and generate income without interruption, even though a change in ownership occurs. … It represents the start-up costs which the buyer would have to incur if the business were started up *de novo*.’[442]

In *Ithaca Industries Inc v Commissioner of Internal Revenue,*[443] the US Court of Appeals for the Fourth Circuit drew a similar distinction, also linking goodwill to patronage, and going concern value to the uninterrupted generation of income:

> While goodwill and going-concern value are often referred to conjunctively, technically going-concern value is the ability of a business to generate income without interruption, even though there has been a change in ownership; and goodwill is a pre-existing business relationship, based on a continuous course of dealing, which may be expected to continue indefinitely.[444]

Such a distinction is not novel. As far back as 1929 in the previously mentioned case of *Haberle Crystal Springs Brewing Co v Clarke,*[445] Judge Swan considered that the owner of a going business enjoys two privileges as a result of that ownership, each of which is property of value. The first was

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440 *VGS Corp v Commissioner* 68 TC 563 (1977); see also G A Baker, ‘Goodwill, Going Concern Become Harder to Avoid’, *Mergers & Acquisitions* (Summer 1984) 58-62; Blaine, ‘Valuation of Goodwill and Going Concern Value’, *Mergers & Acquisitions* (Spring 1979) 4-5, 4; J Paulsen, ‘Goodwill and Going Concern Value Reconsidered’, Mergers & Acquisitions (Winter 1980) 10-13.

441 *Concord Control Inc. v Commissioner of Internal Revenue* 35 TCM (CCH) 1345; *VGS Corp v Commissioner* 68 TC 563 (1977). See also *Butler v Butler* 541 Pa 364, 663 A2d 148 [Pa, 1995].

442 Ronald W Blasi, *US Master Bank Tax Guide* §11.3.4, 552-553 (CCH, 2009).

443 *Ithaca Industries Inc v Commissioner of Internal Revenue*, 17 F3d 684 (4th Cir, 1994).

444 Ibid at [9] citing *Ithaca Industries Inc v Commissioner of Internal Revenue*, 97 TC 253 [17-18].

445 *Haberle Crystal Springs Brewing Co v Clarke* 30 F 2d 219 (2d Cir, 1929).

the privilege of continuing to use the assets of a business to generate income, and the second was the privilege of continuing to deal with the customers of the business. The latter privilege he identified as goodwill. However, while the privileges were distinct, he was careful to point out that the second could only be exercised in conjunction with the exercise of the first. [446]

In their 1983 article 'The Tax Treatment of Going Concern Value',[447] Richard Doernberg and Thomas Hall, assert that the distinction between going concern value and goodwill is made on the basis that going concern value is found in 'the value of the investment needed to establish a business distinct from the value of the business's physical assets',[448] whereas goodwill is 'that element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business'.[449]

However, notwithstanding these distinctions, under generally accepted accounting principles ('GAAP') going concern value is treated as goodwill, and like goodwill under Australian and International Accounting Standards, is only recorded on the balance sheet when the relevant business is acquired.[450]

American judges who distinguish between goodwill and going concern value invariably define goodwill narrowly in terms of patronage.[451] Where they differ from Australian judges who take a similarly narrow approach, is that they go on to recognise going concern value as an additional form of incorporeal property residing within a going business.

Under the rights-based added value concept of goodwill laid down by the High Court in *Murry*, this is unnecessary as the concept is sufficiently broad to encompass both goodwill in a patronage sense, and going value or going concern value as variously described. This is because on the added value approach, goodwill has both a 'patronage' aspect, arising from a business's favourable relationships with its customers, *and* a 'going' aspect, arising from the fact that the business is up and running and generating revenue, and has assembled assets and sunk costs. Under this approach, the fact that the business is a started up, ramped up, income generating, customer servicing entity, will almost invariably give it a value over and above the value of its identifiable

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446 Ibid at 221-222.

447 52 *Geo Wash L Rev* 353.

448 This could be equated with 'start up' costs.

449 52 *Geo Wash L Rev* 353, 355-6 quoting *Los Angeles Gas & Electric Corporation v Railroad Commission*, 289 US 287, 313 (1933) .

450 GAAP are rules, conventions, standards, and procedures that are widely accepted among financial accountants. Since 1973, GAAP doctrine has been established by the Financial Accounting Standards Board (FASB), an independent, self-regulating organization. International Accounting Standards are developed by the IASB. Though the IASB and FASB have come together in most of their functions, they are still different in many aspects. When comparing their origin, the IASB came into existence on April 1, 2001. The IASB deals with the development of International Financial Reporting Standards and promoting the application of these standards. The IASB based in London is an accounting standard setter, which is independent and funded privately. The FASB is based in the United States and came into existence in 1973. It replaced the Accounting Principles Board (APB) and the Committee on Accounting Procedure (CAP). The FASB is a non-profit organisation which caters to the development of GAAP in the interest of the public.

451 A reading of the cases reveals that the motivating factor for distinguishing between goodwill and going concern value in the United States may have been to allow the two intangibles to be treated differently under taxation laws.

assets, regardless of the nature, identity and quantity of its customer relationships.[452] When a purchaser acquires the operating business, he or she obtains the right and privilege to take immediate advantage of all of these benefits, despite the change of ownership. As the *Murry* majority pointed out, such a right and privilege is inseparable from goodwill such that when one acquires one, one necessarily acquires the other.[453] It also explains why the value of 'accounting goodwill' and 'legal goodwill' will usually be identical in a profitable business.[454]

In contrast, when Australian judges define goodwill narrowly and confine it to patronage, going concern value goes largely unrecognised. This is because if 'patronage' goodwill is identified in a business, the business's customer relationships are treated as its only sources, even if those relationships cannot account for the whole of the business's unidentifiable intangible value. Such was the flaw in Justice Southwood's judgment *in Alcan 2* where he identified other sources of value in GALS's business but then felt constrained to ignore them unless he could find some sort of nexus, however tenuous, between those sources and customers being attracted to the business.

Similarly, if no 'patronage' goodwill is identified in a business, perhaps because a business does not have the right kind or number of customers, or does not sell the right kind of product or service, the going concern value in the business is usually allocated to the business's identifiable assets, even if those assets would never transact in the market at the values ascribed to them. Such was Justice Mildren's error in *Alcan 1*, an error which was repeated by President Barker in *Origin Energy* and by Chief Justice Martin in *Alcan 2*.

C. Goodwill, going value and going concern value in the Gove Joint Venture

The decisions in *Alcan 1* and *2* and *Origin Energy* reveal an ongoing judicial confusion about the legal doctrine of goodwill, and in particular, confusion concerning the role played by custom. A fundamental reason for this confusion is a failure to understand where value lies in a business. In both *Alcan* and *Origin Energy* the purchaser paid an amount for the business far in excess of the market value of its identifiable assets. In *Alcan*, a BHP Billiton subsidiary offered the same amount. Whatever the source of this excess value, why would such sophisticated buyers as Alcan, BHP Billiton and Origin Energy agree to pay it? Put simply, what benefits or advantages did they expect to obtain by purchasing the operating business which they would not expect to obtain by purchasing its identifiable assets alone? The answer is each of them expected to obtain, and Alcan and Origin did obtain, a bundle of valuable rights and privileges permitting them to make immediate use of all that constituted the attractive force of the business to generate earnings or otherwise create value without interruption, whether through customer attraction or otherwise, and despite the change of

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452 The only instance where it may not have this excess value is if the business is operating at a loss and is likely to continue to do so for the foreseeable future.

453 *Murry* (1998) 193 CLR 605, 623 [45].

454 An exception to this rule may be the business which is operating at a loss and is likely to continue to do so for the foreseeable future, or the business which for some reason is unlikely to be able to continue generating income. An example of the latter may be a profitable business which is selling a product which is about to be outlawed.

ownership.[455] In *Murry*, the majority identified this bundle of rights as goodwill, while in the United States, some judges prefer to divide the bundle into going concern value in the form of the privilege of continuance, and goodwill in the form of favourable customer relations. However, despite the purported division, and as Judge Swan acknowledged in *Haberle Crystal Springs Brewing Co v Clarke,* the second privilege can only be exercised in conjunction with the exercise of the first.[456]

It follows that, however characterised, the rights and privileges enjoyed by the owner of an operating business are potentially of enormous value, particularly if the business is of a specialised nature, is capital intensive, is inherently risky, or operates in a market which has significant barriers to entry. A bauxite mining and alumina refining business meets all of these criteria and so certainly qualifies as such a business. Arguably so does a co-generation energy business.

By acquiring an operating business rather than a collection of assets, Alcan and Origin each enjoyed the privilege of continuing to exploit the assets and attributes of the business to produce income, and avoided the costs, risks and delays associated with starting up and ramping up a new business. In *Alcan*, both Alcan and BHP Billiton were willing to pay between AUD$380 and $400 million or 48% - 55% of the market value of GAL's business for these rights and privileges. In *Origin Energy*, the amount was approximately AUD$32 million or 45% of the value of FSWCG's business.

To understand why such sophisticated investors were willing to pay such significant sums, one need only identify the costs, delays and risks which Alcan avoided by purchasing an interest in the Gove business rather than in its identifiable assets alone. Similar considerations relevant to an energy business would also apply in Origin's case.

1. The costs component of goodwill in the Gove Joint Venture business

In order to establish a bauxite mining and alumina refining business equivalent to that of the Gove joint venture, a purchaser of its identifiable assets alone would have been exposed to a number of costs. These may have included costs associated with:

(a) locating and hiring management and staff for the mine, refinery and associated facilities;

(b) training workers in the operation of those facilities, and developing expertise in the operation of those facilities;

(c) developing databases and technical manuals etc that are necessary to operate the mine, refinery and associated facilities;

(d) investigating the locations where bauxite is likely to be most fruitfully mined, and the locations which are less promising;

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[455] *Murry* (1998) 193 CLR 605, 623 [45].

[456] 30 F 2d 219 (2d Cir, 1929) 221-222.

(e) developing strategies for mining that bauxite;

(f) developing future mining plans;

(g) obtaining or arranging transfer of the appropriate licences to mine, transport and export bauxite, and to refine, transport and export alumina;

(h) assessing refinery operations to identify opportunities for improvements in throughput, efficiency, or quality of the alumina produced;

(i) evaluating potential modifications to refinery operation and implementing changes to refining procedures;

(j) developing relationships with suppliers (e.g. suppliers of coal and natural gas used in the refining process);

(k) developing relationships with transportation providers (including the railroad used to haul refined alumina to port, and the facilities used to load alumina onto ships);

(l) developing information regarding potential customers for alumina (e.g., their preferences regarding the characteristics of the product they wish to buy, their price sensitivity, and their ability to pay for the product purchased); and

(m) developing accounting systems, human resources policies, occupational health and safety policies, procedures for compliance with various regulatory mandates etc.

A purchaser of the Gove business's identifiable assets alone would have to incur these costs and perform these tasks in order to create a bauxite and alumina business, while a purchaser of the operating business would not. This indicates that the costs and tasks must produce some value. That value is not a component of the market value of the business's identifiable assets. Rather, it is a component of the value of the goodwill of the operating bauxite and alumina business.

2. The delay component of goodwill in the Gove Joint Venture business

While a purchaser of the operating Gove business would have been able to continue production at levels and variable costs consistent with past historical experience, a purchaser of its identifiable assets alone would not have been able to do so. It merely would have purchased an unstaffed idle facility with the potential to earn income. Whatever its knowledge regarding the location, quality and quantity of bauxite deposits and the operation of the mine and refinery, a purchaser of the assets alone would not have enjoyed the benefit of a knowledgeable *in situ* trained and assembled workforce, experienced in the operation of this particular mine and refinery . It would have lacked relationships with customers and suppliers, and it would have needed to develop the remainder of the infrastructure necessary to conduct a business.

The need for the assets-only purchaser to obtain the knowledge and perform the tasks necessary for it to commence production would have resulted in a delay before it would have been able to begin the production of alumina or the export of any bauxite. During this period of delay, the assets-only purchaser would be foregoing, or at least deferring, net cash flows that would otherwise have accrued to the owner of the operating business. Hence, this period of delay would produce an incremental opportunity cost. The amount a purchaser of the going business would be willing to pay for the business would reflect this opportunity cost. This opportunity cost is not part of the value of the identifiable assets but contributes to the value of the goodwill of the operating business.[457]

Even after starting production, the assets-only purchaser might not be able to realize the same margins (and hence the same net cash flows) on its bauxite and alumina as the purchaser of the Gove operating business. There are several reasons why this might be the case. First, for some period after starting production, significant differences might persist between the amount of bauxite that the assets-only purchaser could have reasonably expected to be able to mine and export or process into alumina, and the amount of bauxite that a purchaser of the operating Gove business would have been able to mine and export or process into alumina. Some of the reasons for this difference would be predictable; for example, the assets-only purchaser would need to develop expertise in the management and operation of its newly acquired facilities. In addition, the assets-only purchaser would need to consider the potential that other factors causing reductions in the amount of alumina the facility could produce might unexpectedly arise during the start-up phase; the purchaser of an already-functioning facility would not have to consider these risks since its facility has completed the start-up phase. The assets-only purchaser would take those risks into account when calculating the average amount of alumina it would have expected to be able to produce, as of the time of the acquisition.

Second, for some time after starting production, the variable costs that the assets-only purchaser would have reasonably expected to incur to produce each ton of alumina could be materially higher than the variable costs that the purchaser of the Gove business as a whole actually incurred. Again, this would be partly due to the fact that the purchaser of the business would have purchased an already-functioning facility, while the assets-only purchaser would need to develop expertise in the efficient management and operation of that facility.

Third, similar observations may apply to other characteristics of the refinery's output, as the consistency of the quality of the alumina produced, or the reliability with which that alumina can be supplied to customers, might be lower for some period after the assets-only purchaser has started production. This may or may not have an impact on the prices the new business could achieve for its product.

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[457] In principle, the foregone net cash flows will be partly offset by an extension of the life of the Gove facility. Therefore, if it would take two years for the hypothetical assets-only purchaser to re-establish production, that would be offset by the fact that the hypothetical assets-only purchaser could keep the facility in operation for an additional two years at the end of its lifespan.

While each of these differences would likely dissipate over time, in the years immediately following the time when the assets-only purchaser would have been able to establish operations at the Gove facility, some or all of the differences listed above might be significant, resulting from the fact that the purchaser of the business as a whole is further along the learning curve associated with the operation than the purchaser of the assets, which may result in greater productivity, in greater efficiency (thereby reducing variable costs), or in more consistent quality or greater reliability of supply (thereby permitting higher prices). Decreases in the amount of alumina the assets-only purchaser could have reasonably expected to produce, the quality that it could reasonably expect that alumina to possess, and the consistency with which it could expect that alumina to maintain a given level of quality would decrease the margins from alumina sales that it could reasonably have expected to realize in the years immediately following the purchase, as compared to the margins that the purchaser of the Gove business would have been expected to earn. Increases in variable costs would have the same effect on the margins that the assets-only purchaser would have reasonably expected to realize. This would have the effect of increasing the difference between the market value of the Gove business and the market value of its identifiable assets.

3. The risk component of goodwill in the Gove Joint Venture business

Each of the tasks that a purchaser of GAL's identifiable assets would have to undertake to establish a profitable bauxite and alumina business carries with it a certain level of risk. There are obvious risks such as cost or time blowouts and production losses, and less obvious risks such as increased occupational health and safety risks, or changes in environmental or other legislation or in government policies or regulations which may make it more difficult or expensive to achieve start up, or in some cases may make it legally impossible or uneconomic to do so. A purchaser of the Gove business as opposed to its assets would avoid many or most of these risks and so would likely be willing to pay more for the privilege.

When one considers these costs, delays and risks, it is no surprise that a sophisticated purchaser would pay a substantial amount to avoid them. In Section X below, a proposed method for estimating this amount is advanced.

X. VALUING GOODWILL

A. When traditional valuation methods are unavailable

In *Murry*, the majority endorsed the traditional accounting method as the most appropriate method for valuing goodwill for legal purposes. This method involves finding the difference between the present value of the predicted earnings of the business (or its arms-length purchase price) and the fair value of its identifiable net assets. In a legal inquiry, where the identifiable assets need to be valued with precision, this usually involves obtaining market valuations of those assets and deducting their value from the market value of the business. This is because as the majority observed, particular assets as shown in the books of the business may be under or overvalued.

However, circumstances may arise when goodwill cannot be measured in its traditional residual manner because it is not possible to accurately value one or more of the business's identifiable assets with any precision. Examples include when one of the assets is unique, or where it does not readily change hands in the market either at all, or except in conjunction with other assets or with the business in which it is used. Such was the case in *Alcan* when the asset required to be valued was the land on which the joint venturers conducted mining, refining and associated activities. This land was unique and did not transact in the market place other than in connection with the bauxite mining and alumina refining business in which it was used.

In these circumstances, an alternative method for valuing the land is to value all of the other assets of the business and deduct their value from the total value of the business to arrive at a residual value for the land. This was effectively Mr Lonergan's TDRM methodology in *Alcan*. However, the problem with the TDRM was that as Mr Bryant pointed out, one must first assume there is no goodwill to value and deduct, as goodwill itself is traditionally measured as a residual. This issue continued to confront the parties after the Court of Appeal in *Alcan 2* ordered the matter be remitted to the Commissioner to enable the value of the goodwill to be determined in accordance with the usual accounting approach. The Commissioner made much of it in his special leave application to the High Court where Senior Counsel argued that the focus of a land rich enquiry is the value of land not goodwill. Even so, how could one value GAL's goodwill without first knowing the value of its land, and if one knew that value, one would not need to go through the process of valuing the goodwill.[458]

B. The restoration methodology

In these circumstances, an alternative method of obtaining the value of goodwill (or land or both), is to apply a restoration valuation methodology.[459] To obtain a value for goodwill, one must first estimate the costs that a hypothetical purchaser would incur, the revenues that it would forgo, and the risks it would assume, if, on the relevant date, it purchased the business's identifiable assets only and subsequently undertook the effort to develop a hypothetical business comparable to the actual operating business.

As demonstrated in Section IX C above, to undertake such an exercise, the hypothetical assets-only purchaser would often need to incur substantial costs to re-establish operations. It would also encounter delays before it could begin production, and would therefore have to forego the net cash flows that the purchaser of the business as a whole would have realized, during the period between the acquisition date and the date when the assets-only purchaser would have been able to re-start

458 *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* [2009] HCATrans 076 at [691]-[709]
459 The restoration methodology is described in more detail in the writer's article co-authored with Peter Collinson SC in n 14 above.

production. Also, once production has begun, the margins[460] the hypothetical asset-only purchaser earns might continue to be considerably lower than the margins that would have been earned by the purchaser of the going business as a whole. It might be some time before it could attain the same production levels, profits and costs savings it could have attained if it had purchased the operating business. In addition, the hypothetical assets-only purchaser would assume the substantial risk that costs would blow out and revenue would be deferred longer than anticipated, none of which would be borne by the purchaser of the operating business.

To estimate the value of the goodwill of the operating business, one must then compare the NPV of the actual business as it stood on the acquisition date, to the NPV of the identifiable assets alone with the need to recreate the business. The 'delta' or difference between the two, represents the value of the goodwill of the business – i.e. the value of the bundle of rights and privileges enjoyed by the owner of a going business, including the proprietary right to make immediate use of all that constitutes the attractive force of the business to generate earnings and create value.

The DCF method of valuing a business is appropriate for the purpose of estimating this value. The DCF approach is based upon forecasts of the expected value of future cash inflows and outflows. Each of these inflows and outflows is then converted into its present value through the use of an appropriate discount rate (compounded to reflect the amount of time passing between the present and the time at which the cash inflow or outflow is expected to occur), and those present values are summed to arrive at the risk-adjusted NPV. Under the DCF approach, the value of a business is equal to the NPV of the cash flows it is expected to generate over its lifespan; similarly, the value of a prospective investment is equal to the NPV of the incremental cash flows that would result if that investment were undertaken.

Note that this DCF analysis is not the same as calculating the NPV of the cash flows for the actual business separate from the identifiable assets. Rather, the point is to compare the value of the business as it stood on the acquisition date with all of its assets, to the value of the identifiable assets alone with the need to recreate the business. The difference between the NPVs of the actual going business and the hypothetically restored business approximates the value of the goodwill of the actual business.

In principle, the DCF model could be used to estimate directly the long horizon of returns to the hypothetically restored business. A simplifying assumption would be to assume that after some reasonable period of time the difference between the cash flows that would be realized by the purchaser of the identifiable assets only, and the cash flows that would be realized by the purchaser of the going business is zero. Hence, the difficult problem of estimating the cash flows over

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[460] The distinction between net cash flows and margins is important. In the context of an alumina business such as Gove, margins equal the sales revenue minus variable costs, where variable costs are costs that are directly dependent upon the quantity of alumina produced. All other costs are classified as fixed costs. Net cash flows, on the other hand, are defined herein as sales revenues minus all costs (both variable and fixed).   Therefore, margins minus fixed costs equal net cash flows.

decades for each stream is reduced to the problem of estimating the differences in the cash flows in the near term when they are likely to be materially different. This organizing framework provides a basic structure to guide the assembly of data and the key information needed to determine the value of the goodwill of the business.

Having determined that value, the value of the land can be calculated by adding the value of the goodwill as ascertained by the method described above to the value of the entity's other non-land property and deducting the total from the value of the business enterprise. Alternatively, the value of the land can be determined in a more direct sense by conducting the modelling referred to above but substituting the entity's land for its identifiable assets, thus using a restoration methodology to obtain the 'non-land' value of the business (including goodwill). This 'non-land' value can then be deducted from the value of the business enterprise to obtain the value of the land alone.

A restoration methodology similar to that described above was adopted by the Supreme Court of Western Australia in *Nischu Pty Ltd v Commissioner of State Taxation (WA) ('Nischu 1')*[461] and approved by the Full Court of the Western Australian Supreme Court in *Nischu 2*.[462]

C. ***Nischu*** **and the restoration methodology**

The issue in *Nischu* was whether duty was payable pursuant to section 76AG(1) of the *Stamp Act 1921* (WA), in respect of an agreement dated 30 June 1987 whereby Austamax Resources Ltd agreed to sell to Nischu Pty Ltd all of the issued shares in Murchison Zinc Company Pty Ltd for $24 million. This turned upon whether Murchison was land rich at the time of the acquisition within the meaning of section 76AI(2) of the *Stamp Act*. Murchison's property consisted of a 31.16% interest in the Golden Grove Joint Venture which gave Murchison beneficial ownership as tenant in common of mining tenements, improvements on those tenements, plant and equipment and certain mining information.[463] Some of the mining information was available in public records, such as reports to stock exchanges and other public documents published by joint venturers whose shares were listed on a stock exchange, whereas the balance could not be obtained from such sources and would have to be purchased or reproduced to enable the tenements to be mined.

In *Nischu 1*, Commissioner Zelestis QC approached the task of valuing Murchison's tenements by reference to *Spencer*.[464] For this purpose the hypothetical purchaser of the land (as opposed to the joint venture interest) was taken to have had knowledge of all of the mining information when

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461 90 ATC 4391.

462 (1991) 4 WAR 437.

463 The mining information comprised surveys, maps, mosaics, photographs, electromagnetic tapes, radiometric traces, drawings, memoranda, cores, samples, drill logs, engineering studies, design work, geological, geophysical and other test data, maps and reports, sample and assay reports, notes and other data relating to the tenements.

464 Although Commissioner Zelestis correctly identified the *Spencer* test of market value or value in exchange as the appropriate test, he stated that it was the approach used in determining compensation for compulsory acquisitions. In most cases this is true, although in some cases, if the land has special value to its owners, an additional component of value may be included. This does not occur when land is valued for revenue or most other legal purposes. See *Pastoral Finance Association Ltd v The Minister* [1914] AC 1083.

negotiating a price for the land, but it was not to be assumed that, by acquiring the tenements, the purchaser would also acquire a permanent right of access to, and use of, that information. In this regard Commissioner Zelestis rejected a submission by the Commissioner of State Taxation that the mining information was valueless when considered separately from the tenements to which it related, that in some way the information 'inhered' in the tenements and that a hypothetical willing vendor, keen to maximise the price to be obtained for the tenements, would allow the mining information to pass permanently to the purchaser. The Taxation Commissioner's submissions were wrong because, by the hypothetical purchase, the notional purchaser would simply acquire the relevant land not rights to use information relating to that land.

On those premises Commissioner Zelestis reasoned that, in agreeing upon a price for the land, the hypothetical vendor and purchaser would have regard to the cost of regenerating or otherwise acquiring the important information that would not otherwise be available to the purchaser after the sale. This cost would cause the parties to reduce the price that would otherwise be appropriate for Murchison's land.[465] But this was not the whole of the matter. The evidence further disclosed that such a purchaser would be concerned about a delay in the realisation of income from mining the tenements due to the time taken to do the necessary exploration and further works. In addition, a purchaser would be concerned about the risk of incurring unexpected costs in regenerating the information and risks associated with having to negotiate terms on which to participate in a joint venture. Commissioner Zelestis identified the following method for ascertaining the value of Murchison's interest in the tenements alone:

> In my opinion, it should thus be assumed that the hypothetical purchaser and vendor, negotiating the sale of Murchison's interest in the tenements alone, knowing that some of the mining information was available from public records, but that considerable valuable information would have to be regenerated or otherwise acquired by the purchaser at considerable cost (for example, by paying those entitled to it for access to, and use of, it), *would agree upon the price payable for the interest in the tenements by taking the value of Murchison's property and agreeing upon a deduction from that value in order to take into account several factors.* Those factors are *the cost of replacing the information, costs or losses resulting from consequential delay in the development of the tenements*, the fact that the purchaser would probably incur costs in obtaining the right to become a party to a joint venture agreement with the other joint owners of the tenements and thereby benefit from established management and funding of the joint venture activities, and *the general disadvantage to the purchaser of this situation* including, for example, the risk of unforeseen costs to which he would become exposed.[466] (emphasis added)

In considering the amount of this deduction, Commissioner Zelestis held that the hypothetical parties would have regard to, and be guided by, discounted cash flow analyses comparing the calculated value of the joint venture property (including the information) with that of the tenements

465 *Nischu 1* 90 ATC 4391, 4397.
466 Ibid 4399.

alone.[467] The DCF evidence before him indicated that the value of Murchison's land was significantly less than $19.2 million (that is, 80% of $24 million). The same result was reached by first considering Murchison's 31.16% of the estimated cost, namely $10 million, of reproducing the necessary part of the mining information. If that cost were to be deducted from the value of Murchison's property, it would require a deduction of $3,116,000. While Commissioner Zelestis found that it was difficult on the evidence before him to assess the total deduction (on account of the other factors such as deferred revenue and general disadvantage including risk), he concluded that the other factors would warrant a sum measured in millions of dollars and that the total deduction from the value of a 31.16% interest in Murchison's property would 'far exceed' 20% of the value of total property of $24 million.[468]

Commissioner Zelestis did not find it necessary to characterise this 20% of the value of Murchison's property other than to find that it was not 'land'. However, on a proper analysis, the amount represented by the costs which would be incurred and revenue which would be foregone, and the risks which would be assumed if one purchased the land only rather than the joint venture business, was Murchison's proportion of the goodwill of the Golden Grove Joint Venture business. This goodwill had no source in the business's custom, but rather its primary source was the confidential mining information. When Nischu acquired the shares in Murchison, it also acquired the bundle of rights and privileges enjoyed by Murchison as part owner of the joint venture business, including the right to make use of the mining information. While the information itself was not property,[469] the goodwill it contributed to was property and this was of sufficient value to avoid the land rich threshold.

On appeal in *Nischu 2*, the primary decision was unanimously endorsed by a Full Court comprising Malcolm CJ, Wallace and Pigeon JJ. More particularly, the Full Court approved the way in which Commissioner Zelestis applied the valuation principles derived from *Spencer* to determine the 'real and true value' of the land.[470] The Commissioner's application for special leave to appeal the decision to the High Court was dismissed.

It follows from the *Nischu* decisions that, in circumstances where it is not possible to value land because it does not transact in the market absent the business in which it is used, or where it is not possible to measure a going business's goodwill as a residual of total business value because it is not possible to value the business's identifiable assets with precision; an alternative method to value either the land or the goodwill is to apply the restoration methodology. If such a methodology had been used in *Alcan*, given the potential costs, delays and risks which were identified earlier in this thesis as having being avoided by Alcan, it is likely that the value of Alcan's land would not have exceeded 60% of the value of its total property.

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467 Ibid 4399.
468 Ibid 4400.
469 Ibid 4395; *Pancontinental Mining Ltd v Commissioner of Stamp Duties* [1989] Qd R 310.
470 *Nischu 1* 90 ATC 439, 443.

XI. CONCLUSION

It is apparent that rather than dispel the confusion surrounding the legal doctrine of goodwill, *Murry* has in many ways led to its increase. Initially this was because some judges remained reluctant to depart from the practice of subdividing goodwill into component parts and allocating its value to one or more of the business's identifiable assets which he or she considered to be the source of that goodwill. Unsatisfactory as this practice was, it at least accepted that to a greater or lesser extent operating businesses had goodwill for legal purposes. However, in more recent times, some judges have departed even further from the majority's reasoning to deny the legal recognition of goodwill to any business which does not have the right kind or number of customers or offer the right kind of product or service. It was this resurrected patronage approach to goodwill which led Mildren J in *Alcan 1*, Barker P in *Origin Energy* and Martin CJ in *Alcan 2* to conclude that the sophisticated and highly profitable businesses the subject of their legal inquiries had no goodwill. As a result, each judge was compelled to find an alternative repository for the excess value which was clearly present in the relevant business. In *Alcan* it was the fixed plant and equipment. In *Origin Energy* it was the sales contracts. In each case, this resulted in the value of those assets being distorted far beyond their market value potentially exposing the taxpayer to a significant liability to stamp duty. Such an outcome does no justice to the efforts of the majority in *Murry* and could never have been their intent.

Even in *Alcan 2* where Southwood J found that goodwill did exist, he confined its sources to those attributes which directly attracted or maintained custom, and by some fairly tortuous reasoning, to other attributes and advantages which 'positively affected' those attributes. At the same time, he acknowledged that the business had other attributes and advantages which also added value to it without necessarily having any effect on custom. This led him to query whether these other attributes and advantages might be evidence of a second form of parasitic incorporeal property in a going business which was separate from goodwill.[471]

The judges in *Alcan* and *Origin Energy* who erred did so because they were persuaded that the *Murry* majority had laid down a legal concept of goodwill which was *narrower* than the accounting or business concept. In fact the justices were doing the opposite; stating that goodwill may exist for legal purposes whether or not a business is profitable and regardless of whether its value exceeds that of its identifiable assets. In this way, their Honours sought to distinguish between the *existence* of goodwill on the one hand, and its *value* on the other. Consequently, the legal concept of goodwill is *wider* than that known to accountants and business people, and may exist even when such persons would not consider it to be present. This is not to say that 'legal goodwill' and 'accounting goodwill' are totally unrelated concepts. Although different in theory and in nature, in terms of value they are effectively synonymous, and in the context of a profitable business can usually be

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471 *Alcan* (2008) 24 NTLR 33, 73 [133].

measured in exactly the same manner. This is because it is the bundle of rights and privileges able to be enjoyed by the owner of an operating business which facilitates its profit making and assists the business to attain the 'excess value' which accountants call goodwill.

Even if the business is unprofitable, because for various reasons the business owner has not been able to use this bundle of rights and privileges in such a way to as to generate earnings, the rights and privileges still exist, even if they do not presently translate into excess value. However this is not always the case, as in some circumstances, although the business be unprofitable, the rights and privileges enjoyed by its owner may nonetheless have considerable market value. Cases where this may be so include where the business operates in an industry where there are significant barriers to entry, or where poor management or lack of available capital may be the principal reason for the business's unprofitability. Under new management, or with an appropriate injection of capital, the business may become extremely profitable and so notwithstanding its present unprofitability, it may have significant excess value.

But regardless of their value, or even if they have no value, the rights and privileges exist for legal purposes and therefore so does goodwill. This is because goodwill for legal purposes is rights-based and exists irrespective of value, while goodwill for accounting purposes is value-based and exists only if it has commercial value. This is demonstrated most effectively by the fact that the law may move to protect a business's sources of goodwill, such as by awarding an injunction to prevent the passing off of its product or the misuse of its name, even if the business is unprofitable or has no excess value or goodwill in an accounting sense.

Ultimately, a rights-based theory of goodwill which takes an 'added value' approach is correct because it is consistent with the High Court's analysis in *Murry*. Rather than confine the legal recognition of goodwill to circumstances akin to a corner shop where patronage is the touchstone of the business, the High Court liberated the doctrine to encompass operating businesses of all kinds thereby enabling the law to remain relevant in a sophisticated and rapidly changing market place.

For this reason, it may be time to distance the modern rights-based doctrine of goodwill from its historical patronage-centred past and rename it 'operating business value'; because on its proper construction, goodwill which is recognised by law exists whenever a business is operating and generating revenue and there is reason to believe that this will continue. What follows is that every such business necessarily possesses goodwill in a legal sense, and it is simply irrelevant to the existence of that goodwill where the custom of the business is drawn from, how much custom is drawn, or whether the business has the capacity to draw further custom. Nor is there any need to prove some sort of causal connection between that custom and particular assets, attributes or advantages of the business. It is the right to make use of all of the business's assets, attributes and advantages to generate earnings or otherwise create value which constitutes goodwill in a legal sense. For all of these reasons, both *Alcan 1* and *Origin Energy* miscarried, and even though *Alcan*

1 was reversed on appeal, the reasons of two of the three appellant judges in *Alcan 2* reveal a continuing misunderstanding of *Murry*.

The High Court had an opportunity to revisit the legal concept of goodwill when *Alcan 2* went on appeal and cross-contention in *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue*.[472] The Commissioner appealed to the High Court asserting that the Court of Appeal erred in its finding that GAL had substantial goodwill and Alcan cross-contended that under the relevant statute, an option to renew a lease is not 'land'. The High Court heard argument in relation to Alcan's contention and found in its favour. In the circumstances, it did not need to hear argument on, and was not required to determine, the Commissioner's appeal on the goodwill grounds. The outcome is that the legal concept of goodwill may continue to be misunderstood until a further opportunity arises. If the conduct of Commissioners past is anything to go by, that further opportunity may well arise in the context of a resource entity facing a significant land rich or land holder stamp duty inquiry, a capital gains tax inquiry or perhaps even an assessment of tax under the impending mineral resources rent tax scheme, any of which could necessitate an inquiry into the existence and value of the entity's goodwill.[473] In any event, the battle over the legal doctrine of goodwill is far from over and is likely to continue to occupy both courts and commentators for some time to come.

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472 (2009) 260 ALR 1.

473 See Osborn and Collinson, above n 14 for a discussion of the relevance of goodwill to a capital gains tax or mineral resources rent tax inquiry.

XII. GLOSSARY

AASB	Australian Accounting Standards Board
API	Australian Property Institute
CSRI	CSR Investments Pty Ltd
DCF	discounted cash flow
DORC	discounted optimised replacement cost
DRC	discounted replacement cost
FASB	Financial Accounting Standards Board
FCSWCG	Fletcher Challenge SouthWest Cogeneration Ltd
GAAP	generally accepted accounting principles
GAL	Gove Aluminium Limited
GAVP	generally accepted valuation principles
HSH	HSH Hotels (Australia) Ltd
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
ITAA	*Income Tax Assessment Act* 1936 (Cwth)
IVS	International Valuation Standards
IVSC	International Valuation Standards Council
MEA	Master Energy Agreement
NPV	net present value

PPA	Power Purchase Agreement
SAT	State Administrative Tribunal
SWCJV	South-Western Cogeneration Joint Venture
S & P	Standard & Poors
TDRM	top down residual method
WAPLJV	Worsley Alumina Pty Ltd Joint Venture

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