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# GOODWILL AND ITS FEDERAL INCOME TAX ASPECTS

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It is doubtful whether goodwill can be defined clearly and accurately. First of all, it seems apparent that goodwill, unlike other items of value, has no independent existence of its own. The early legal opinions, which set forth definitions, are concerned more with that to which goodwill attaches than with that of which it consists. Among the best known of these early definitions was that of the Lord Chancellor Eldon in a case where the sale of the goodwill of a country waggoner was in litigation. He stated that goodwill "is nothing more than the probability that the old customers will return to the old place."<sup>1</sup>

A much broader and more comprehensive definition is set forth by Judge Story in a frequently quoted statement:

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 necessities, or even from partialities or prejudices.<sup>2</sup>

Goodwill is not a single item but consists of a number of commercial advantages and benefits.<sup>3</sup> Thus goodwill has been defined as the friendliness which a consumer has toward a particular product,<sup>4</sup> it includes an established firm<sup>5</sup> or trade name, a specific or general location,<sup>6</sup> a reputation for service, personal attention, or reasonable price.<sup>7</sup> It may consist of a good name for honesty, competence and fair dealing<sup>8</sup> or it may take the

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<sup>1</sup> Crutwell v. Lye, 34 Eng. Rep. 129, 134 (1810)

<sup>2</sup> *Story on Partnerships*, Sec. 99.

<sup>3</sup> For good summaries of both the legal and accounting definitions of goodwill see: Gabriel A. D. Preinreich, *The Law of Goodwill*, 9 *The Accounting Review* 317-329 (1936); Preinreich, *Goodwill in Accounting*, 64 *Journal of Accountancy* 28-50 (1937).

<sup>4</sup> *Pecheur Lozenge Co. v. National Candy Co.*, 36 F. Supp. 730, 733 (D., N. J., 1940).

<sup>5</sup> *Washburn v. National Wall Paper Co.*, 81 Fed. 17 (C. C. A. 2d 1897).

<sup>6</sup> *Metropolitan Bank v. St. Louis Dispatch Co.*, 36 Fed. 722.

<sup>7</sup> *Burke v. Canfield*, 121 F. 2d 877, 880 (app., D. C. 1941).

<sup>8</sup> *A. Harris & Company v. Lucas*, Commissioner of Internal Revenue, 48 F. 2d 187, 189 (C. C. A. 5th, 1931).

form of a vendor's covenant not to compete,<sup>9</sup> a medal or certificate of merit, or a franchise. But these various types of goodwill are also interdependent. This relationship has been stated in the following manner:

The policies and condition from which goodwill emerges are generally interrelated to a degree which makes it impracticable to segregate the financial effects of specific factors. . . . Good relations with employees have a bearing on the quality and price of the product and thus exert an indirect influence upon the attitudes of the customers. Advantageous financial relationships likewise are more likely to reflect the presence of intangible value resulting from the character of management and demonstrated earning power than to constitute a major factor in its formation.<sup>10</sup>

Goodwill cannot exist separate and apart from a going concern. It is parasitic.<sup>11</sup> The study of goodwill, in a sense, is a study of the ways and means of making it transferable. Many forms of goodwill originally arose from personal efforts or qualities and now differ only to the extent to which it is possible to separate them from persons and attach them to a tangible object or visible sign which may be transferred.

#### VALUATION OF GOODWILL

The Bureau of Internal Revenue and many courts have related the nature of goodwill to its method of valuation. The more widely accepted approach in the accounting field is to explain goodwill as that ability to earn "super-profits". As stated by P. D. Leake:

Goodwill, in its commercial sense, is the present value of the right to receive expected future super-profits, the term "super-profits" meaning the amount by which future revenue, increase or advantage to be received, is expected to exceed any or all economic expenditure incidental to its production.<sup>12</sup>

The Bureau's attitude was indicated in an early ruling<sup>13</sup> when it stated that "goodwill" should be given "not merely the narrow and technical meaning which has been attached to it in numerous court decisions," but that it should "include as well the intangible value which always attached to a more than usually profitable enterprise by reason of its proven earning capacity."

Accountants generally will not record goodwill on the books and records of an enterprise unless it has been purchased. In

<sup>9</sup> *Crutwell v. Lye, supra.*

<sup>10</sup> W. A. Paton, Editor, *Accountants Handbook*, (3rd Ed.) 846 (1949).

<sup>11</sup> *Burke v. Canfield*, p. 880, *supra.*

<sup>12</sup> P. D. Leake, *Goodwill: Its Nature and How to Value It*, (1914) p. 4.

<sup>13</sup> A. R. R. 252, 3 C. B. 46.

such circumstances goodwill would be valued by determining "the excess of the price paid for a business as a whole . . . over the computed or agreed value of all tangible net assets acquired."<sup>14</sup> This is the same approach used by the Board of Tax Appeals in several tax cases.<sup>15</sup> Of course in certain instances this method of valuing goodwill is the only satisfactory method since it uses the monetary value of what a willing buyer and seller agree to.

From the income tax viewpoint the use of a value arrived at by a willing buyer and seller is too limited. Although it is possible to use such an approach in some cases, it certainly cannot be used where no arms-length transaction has taken place. For example, if a closely held corporation liquidates and its going business is taken over by the stockholders who thereafter operate as a partnership no arms-length transaction has taken place and it becomes necessary to calculate the value of the goodwill.

Quite early in the development of the income tax law, the Bureau issued a ruling<sup>16</sup> setting forth a method of determining the value of goodwill. If a business is such that when properly managed it will not yield a profit, it is not a desirable business and its goodwill cannot be considered of any value to a prospective purchaser. Goodwill is the chance of expectancy of securing a future profit. Therefore in valuing goodwill it must be remembered it is a problem concerned with the future and not with the past. But past events must be considered because they are essential guides as to expected future earnings.

The income tax method of determining the value of goodwill as explained in A.R.M. 34<sup>17</sup> is calculated in the following manner. (1) Determine the average tangible assets for a period of five or more years. (2) Take a definite percentage (e.g., 10 percent) of the average tangible assets as representing an average or normal return on the investment in tangible assets. (3) Determine the average actual earnings for a period of five or more years. (4) Determine the excess of the actual earnings (as determined in the preceding step) over the normal return (as determined in step 2). This represents the super-profits. (5) Capitalize these super-profits at some definite rate (e.g., 20 percent). This amount represents the value of goodwill.

The normal rate of return on the investment in tangible assets and the capitalization rate will vary in each case. For example, a less hazardous business would probably use 8 percent and 15 percent respectively instead of 10 percent and 20 percent.

The above method clearly relates the value of goodwill to

<sup>14</sup> Eric L. Kohler, *A Dictionary for Accountants*, (1952) p. 205.

<sup>15</sup> M. Werk & Co., 15 B. T. A. 954 (1929); American Seating Co., 4 B. T. A. 649 (1926); Market Supply Co., 3 B. T. A. 841 (1926); Rockford Brick & Tile Co., 4 B. T. A. 313 (1926).

<sup>16</sup> A. R. M. 34, 2 C. B. 31. Other rulings pertaining to the computation of goodwill are A. R. R. 2954, II-2 C. B. 202; S. M. 1609, III-1 C. B. 48; S. M. 2435, III-2 C. B. 20; S. R. 5545, IV-2 C. B. 242.

<sup>17</sup> *Ibid.*

the theory of super-profits and bases its value on past experience. In other types of court cases other methods have been used to value goodwill. One arbitrary method quite commonly accepted in the state courts<sup>18</sup> is the three or five year purchase method. A return of a certain percentage (e.g., 6 percent) is allowed on the net investment. This return is deducted from the average actual profits and the difference multiplied by three or five years.

Even more arbitrary is that method where the goodwill is determined by multiplying the actual average profits by 3, 5, 10, or more years.<sup>19</sup>

The Bureau's method in the valuation of goodwill generally has been followed by the courts in those cases involving income tax. This approach involves a better grasp of the fundamental principles of valuation of goodwill since super-profits are used in its calculation.

#### DISTINCTION BETWEEN GOODWILL AND OTHER ASSETS

It should be fairly obvious that the mere existence of super-profits does not always assure the existence of goodwill. It is certainly possible that an enterprise may show above normal profits and have it attributed to some intangible<sup>20</sup> asset other than goodwill. Perhaps the greatest deficiency in the opinions of the courts dealing with intangibles generally has been a failure to distinguish between goodwill and other intangible assets also possessing value, a failure which has possibly been due to the manner in which the cases have been presented to the courts. Most of the decisions involving federal taxes have dealt with March 1, 1913 value of a business or the value of an interest in a closed corporation or partnership. Since in these cases both the court and counsel have had their attention directed primarily to the question of whether *any* intangible value exists, the term goodwill was often used loosely. The designation of all and sundry intangible values as goodwill didn't make any great difference in the resulting tax consequences. However the distinction between goodwill and other intangibles is present in many tax questions today and is quite important. But the picture is still not very clear and perhaps the Supreme Court's comment in 1893 is still true when it said, "Undoubtedly goodwill is in many cases a valuable thing, although there is difficulty in deciding accurately what is included under the term".<sup>21</sup>

The goodwill of many enterprises has been built through the efforts and ability of a single individual. That such personal goodwill was thought not to be transferable was recognized early.<sup>22</sup>

<sup>18</sup> For example see: *In re Demarest*, 157 N. Y. S. 653, 655.

<sup>19</sup> For annotations see: 24 A. L. R. 1046; 57 A. L. R. 1163.

<sup>20</sup> As used in this paper intangibles have reference to those assets having no physical existence, its value being dependent on the rights that possession confers upon the owner.

<sup>21</sup> *Metropolitan Bank v. St. Louis Dispatch Co.*, 149 U. S. 446.

<sup>22</sup> *Mandeville v. Harman*, 42 N. J. Eq. 185.

But it doesn't necessarily follow that goodwill built up by the efforts of an individual cannot be transferable. In partial recognition of the personal goodwill and to assure the purchaser of a going business protection from loss of this goodwill, a covenant not to compete is entered into by the seller. This keeps the seller out of certain specified trade area for a limited period of time. From the viewpoint of the income tax aspects of the problem, it is important to segregate the value assigned to an agreement not to compete from goodwill.<sup>23</sup> The value assigned to the agreement not to compete can be amortized by the purchaser so as to reduce taxable income<sup>24</sup> but goodwill cannot be amortized or depreciated.<sup>25</sup>

The taxability of personal goodwill has been at issue in several tax cases.<sup>26</sup> The knowledge, experience, ability, skill, acquaintanceship and other personal characteristics of individual employees do not constitute goodwill regardless of the fact that they may be of substantial commercial benefit to the business enterprise.

Other intangibles that have been confused with goodwill are franchises, patents, and copyrights. Each of these items can have a definite legal life and as a result can be amortized or depreciated for income tax purposes. In a 1946 case<sup>27</sup> involving an automobile dealer's franchise the court held that no goodwill value could be assigned to a business where whatever goodwill was possessed was connected with the franchise and such franchise could be terminated without notice or cause.

If any of the super-profits of the business are due to the patents, licenses, franchises, or copyright, deduction for depreciation will be permitted over the useful life of such assets.<sup>28</sup>

#### INCOME TAX SITUATIONS INVOLVING GOODWILL

There are several possible cases where goodwill enters into the tax considerations. Care must be exercised to recognize that the problem is present—otherwise serious tax consequences will result. Most of these cases involve problems of valuation and can be summarized in the following manner:

(1) *March 1, 1913 values.* Prevalent in the earlier tax cases have been those situations where the March 1, 1913 value has been at issue. In determining the proper basis of an asset acquired prior to March 1, 1913, it is necessary to know its fair value as of March 1, 1913. Therefore it is essential to establish the value of goodwill of a going business in order to establish its proper tax basis.

<sup>23</sup> For a case that discusses this distinction see Aaron Michaels 12 T. C. 17.

<sup>24</sup> B. T. Babbitt, Inc., 32 B. T. A. 693 (1935).

<sup>25</sup> Sec. 29.23 (1)-3 of Regulations 111.

<sup>26</sup> Providence Mill Supply Co., 2 B. T. A. 791 (1925); Northwestern Steel & Corp., 6 B. T. A. 119 (1927); D. K. MacDonald, 3 T. C. 720 (1940) acq., 1944 C. B. 18; Howard Lawton, 6 T. C. 1093 (1946) acq., 1946-2 C. B. 3, revd. on other grounds, 164 F. 2d 880 (C. C. A. 6th, 1947).

<sup>27</sup> Floyd D. Akers, 6 T. C. 695 (1946).

<sup>28</sup> Sec. 29.23 (1)-3 of Regulations 111.

(2) *Change in the organizational form of a continuing business.* If a closely held corporation liquidates and the stockholders continue to operate the business as a partnership, the transaction, being a taxable exchange, calls for the calculation of a taxable gain or loss. Essential to this calculation is the determination of goodwill presently existing in the business. This sometimes can be true in the case of changing a partnership to corporate form of business organization.<sup>29</sup>

(3) *Depreciation or obsolescence.* If goodwill has a tax basis<sup>30</sup> generally no depreciation or obsolescence will be allowed. The regulations are quite specific on the point.<sup>31</sup> Furthermore the Supreme Court has ruled that no deduction is permitted.<sup>32</sup>

(4) *Sale of goodwill.* If goodwill has a tax basis a gain or loss can result upon a subsequent sale or exchange.<sup>33</sup> If goodwill has no tax basis a gain can result upon its sale in conjunction with the sale of a going business. Since goodwill does not fall within any exceptions to the Internal Revenue Code definition<sup>34</sup> of the term, it would appear to be a capital asset. In most court cases it has been assumed to be a capital asset.<sup>35</sup>

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## MEDICAL ASPECTS OF TRIALS EXPLAINED

A new monograph on "The Medical Aspects of Negligence Cases" has been published by the Practising Law Institute. Written by Charles Kramer, an active trial lawyer of the New York firm of Kramer & Dillof, it explains the tactics and techniques of expert trial lawyers.

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<sup>29</sup> Most such exchanges can generally qualify as non-taxable under Sec. 112 (b) (5) of the Internal Revenue Code.

<sup>30</sup> Usually goodwill can only acquire a tax basis if purchased or if in existence as of March 1, 1913.

<sup>31</sup> Sec. 29.23 (1)-3 of Regulations 111.

<sup>32</sup> *Clarke, Collector v. Haberle Crystal Springs Brewing Company*, 280 U. S. 384 (1930).

<sup>33</sup> Sec. 29.22 (a)-10 of Regulations 111.

<sup>34</sup> Sec. 117 (a) (1).

<sup>35</sup> *Ensley Bank & Trust Co. v. U. S.* 154 F. 2d 968, 969 (C. C. A. 5th, 1946) cert. den. 329 U. S. 732 (1946).