BETWEEN: Toronto 1966 Dec. 8 — Dec. 9

WILLIAM E. BUTLER ET ALIOS ....APPELLANTS;

AND

THE MINISTER OF NATIONAL REVENUE ....} RESPONDENT.

Income tax—Deductions—Purchase of accounting and bookkeeping practices—List of clients and clients' records—Whether part of goodwill—Whether "tangible assets"—Capital cost allowances—Income Tax Act, Sch. B, cl. 8.

In 1962 appellants purchased an accounting practice and a bookkeeping practice in Ontario. By the sale agreements $8,001 was allotted to the goodwill of the practices and $16,600 to lists of clients and various records relating to the clients' businesses. Appellants each claimed a deduction with respect to the expenditure of $16,600 in computing their incomes for 1962.

Held, the lists of clients and related records were of value only if appellants kept the clients, i.e. the chief and primary value of the documents arose from their connection with the tangible asset good will and they were therefore not "tangible assets" within the meaning of clause 8 of Schedule B of the *Income Tax Act,* which authorizes the deduction of capital cost allowances in respect of tangible assets.

APPEALS by William E. Butler, C. Bruce Magee, Alan George Bowers and William V. Curran from income tax assessments.

David A. Ward and *Thomas I. A. Allen* for appellants.

L. R. Olsson for respondent.

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GIBSON J.:—On this hearing four appeals are being considered, all relating to the 1962 taxation year of the appellants. The issue is the same in all appeals. Because of this an Order was made at the commencement to try all four appeals on the same common evidence.

Each of the appellants is a partner in James M. Dunwoody & Company. In the taxation year 1962 this partnership bought accounting practice of Morphy, Boyter & Adams of Trenton, Ontario for the sum of $20,000, and the bookkeeping practice of Lola and Frank Corcoran of Long Sault, Ontario for the sum of $5,101. The respective allocation of the purchase moneys in each of the said agreements was as follows, and I quote from the respective formal agreements.

In respect to the Trenton purchase Clause 2 is the relevant clause and reads as follows:

> 2. The Purchasers shall pay to the Vendors in consideration of the purchase described in Paragraph 1 above as follows:

(*a*)	Goodwill	$ 8,000.00
(*b*)	List of all present and past clients of the said practice, historical records, working papers, financial statements, reports, ledger cards, files and other records pertaining to businesses audited and serviced by the Vendors, which are the property of the Vendors	$ 11,500 00
(*c*)	Furniture and fixtures	$ 500.00
		$ 20,000 00

In respect to the Long Sault agreement, the relevant clause therefrom is Clause 4-A which reads as follows:

> 4. The Purchasers shall pay to the Vendor in consideration of the purchase described in Paragraph 1 above as follows:
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> (*a*) For the Bookkeeping Practice the amount of $5,101.00 subject to adjustments as set forth in this agreement, for assets acquired as follows:

I	Goodwill	$ 1.00
II	List of all present and past clients of the Bookkeeping Practice, historical records, working papers, ledger cards, files and other records pertaining to the services provided as set out on Schedule "A" to this Agreement	$ 5,100 00
		$ 5,101.00

The issue for decision is what is the proper tax treatment of the total sum of $16,600 made up as may be noted of $11,500 referred to in the so-called Trenton Agreement and $5,100 referred to in the so-called Long Sault Agreement. The issue may be put in this way: Was $16,600 or any part of it paid for the acquisition of (and I use the words employed in the so-called Trenton Agreement) lists of all present and past clients of the said practice, historical records, working papers, financial statements, reports, ledger cards, files and other records pertaining to businesses audited and serviced by the vendors which are the property of the vendors? (Compare the wording in the so-called Long Sault Agreement above detailed which in essence is similar). If any amount was paid for the same, is such an amount deductible as an expense for tax purposes in the taxation year 1962 as, *inter alia,* a once and for all expenditure and one not paid out to purchase an enduring advantage, and also of course an expenditure for the purpose of earning income within the meaning of section 12(1)(*a*) of the *Income Tax Act*? Or, if not, was it, while still an expenditure for the purpose of earning income within the meaning of section 12(1)(*a*) of the Act, a capital outlay within the meaning of section 12(1)(*b*) of the Act? And if it was a capital outlay, were tangible assets acquired in consideration therefor within the meaning and so as to entitle the appellants to capital cost allowance under Clause 8 of Schedule "B" of the Regulations of the *Income Tax Act*?

In my view, the issue may be determined by answering two questions, namely, firstly, what is purchased goodwill? And, secondly, are these lists of present and past clients, working papers, etc., as more particularly categorized and referred to above in the said two Agreements "tangible assets" within the meaning of Clause 8 of Schedule "B" of the *Income Tax Act*?

To answer the first question, in my opinion, it is sufficient for the purposes of this action to mention only a few of the *indicia* of purchased goodwill. Some are as follows: (1) Purchased goodwill cannot be purchased as a separate item of a business, but instead is intimately connected with and inseparable from the other assets and liabilities of the business which is purchased as a going concern. (2) The

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general concept of goodwill has been a growing one and has progressively changed so that it now not only pertains to customer or client relations, to which it was considered confined at one time, but also in its current broader meaning encompasses almost any intangible factor of economic value to an enterprise; and the factors underlying goodwill may be considered to affect either greater total revenues or decreased unit costs. (3) The valuation of goodwill, is not a precise science, so that what is actually paid for purchased goodwill in practice is seldom arrived at by any theoretically sound calculation. Instead, in all cases it is a negotiated comprised amount agreed upon by the vendor and the purchaser. And in paying for purchased goodwill there is never any assurance that the purchaser will get the benefit of the goodwill he paid for or that he will not lose some or all of it after purchase.

The answer to the second question is that the documents referred to in the said Agreements, namely, the lists of all present and past clients of the practice, historical records, working papers, etc., are of value only if the purchaser keeps the client, except for some negligible value if some information might subsequently be requested by and given from these documents to the new accountant of a lost client on a fee basis. The chief and primary value of these documents by reason of this fact arises from their connection with the intangible asset, goodwill, and if any client is lost, to whom these documents relate, the purchased goodwill abates ratably. In such event, such documents have a negligible value as a tangible asset consisting of the worth of the paper on which the records are kept when sold as scrap paper, or the negligible amount that might be received in fees from the problematical referrals referred to above. In other words, the chief or primary value of these documents is extrinsic rather than intrinsic. For all practical purposes, and for the purposes of and in the meaning those words are employed in Clause 8 Schedule "B" of the Regulations to the *Income Tax Act* these said documents are not tangible assets.

It follows, therefore, from the answers to the above two questions, that the whole of the $16,600 referred to above, which was paid by the appellants in the acquisition of these two practices, was expended for the goodwill of them.

It is of interest to note, in connection with this matter, the opinions of two leading accountants, one a Canadian, and the other a citizen of the United States. The first opinion is contained in the Canadian Institute of Chartered Accountants publication, the Canadian Chartered Accountant[1], and is that of Mr. Clem L. King, F.C.A. The article is entitled "Valuation of an Accounting Practice". Certain excerpts from this article are as follows:

> In this discussion, the goodwill of an accounting practice is taken to be the value of the "right of access" to the clientele of the practice under valuation. It is the present value of fees expected to be earned by the new owner or owners as a result of the purchase of the practice. "Value" is naturally taken to be the dollar amount agreed to be paid. No comment will be made as to the value of the furniture and equipment, leases, leasehold improvements, and accounts receivable since these can be dealt with separately from goodwill. If they are to be sold, relatively little problem arises in arriving at a mutually satisfactory valuation.
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> Goodwill valuations based on net profits usually fall between one and three times average annual net profits.
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> The valuation may be computed as a percentage of gross fees.
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> Amounts reputed to have been paid in Canada in the last number of years have ranged from under 75% of one year's gross fees to 125% of one year's gross fees paid in one amount or, in a few cases, over a period of years. In the United States, prices paid are reputed to have ranged from 45% to 200% of one year's gross fees. Since full information is not available as to the nature of the practices sold, the circumstances of the sale, and the manner of computing "gross fees", these price ranges can only be regarded as broad generalizations.
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> The valuation may be computed as a percentage of the gross fees expected to be earned by the purchaser over an agreed upon period of years in serving clients to be retained with the amount to be paid in annual instalments. In this method the annual instalments are reduced by the appropriate percentage of fees not so retained.
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> Depending upon the rates and nature of fees and the other pertinent circumstances, goodwill has been reputed to have been valued in Canada at from one to three times average annual net profits, or from 75% to 125% of one year's gross fees.
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> While the foregoing may be taken as guides in valuing good will, the circumstances of practices vary so widely that each valuation must be regarded as a separate problem. In each instance both purchaser and vendor must consider all circumstances and arrive at a mutually acceptable valuation.

The second opinion is contained in the American Institute of Certified Public Acountants Incorporated[2], Jour-

[1] November 1959 issue.

[2] October, 1965 issue.

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nal of Accountancy. It is entitled "The Purchase, Sale and Merger of Small Practices." The article is written by Mr. Richard C. Rea, C.P.A., managing partner of Rea & Associates, New Philadelphia, Ohio. Certain excerpts from this article are as follows:

> And now we come to the most important consideration: the value of the practice.
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> . . .
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> It is generally believed by small practitioners and small firms that their practice is worth one year's gross fees.
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> Many practitioners have held out too long for one year's gross fees because they believed that is what a practice is worth.
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> . . .
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> "Gross fees" is just a good index of the size of a practice, and serves as a convenient basis for establishing the terms of the pay-out.
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> I discovered that the price ranged from as low as 50 percent of one year's adjusted gross fees to a high of 150 percent.
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> The length of time for the pay-out ranged from as short as three years to as long as ten years.
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> In only a few cases was the pay-out fixed at a definite amount per year. Payment of interest on the unpaid balance was rare, and occurred usually where the price was for a fixed amount.
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> Lump-sum payments were made only in unusual circumstances, generally where the practice was very small, the price was low, and the seller was extremely anxious to dispose of the practice.
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> Down payments are usually nominal. In those cases where down payments were substantial, my correspondents stated that this was a mistake and they would not do it again. The large down payment, they said, plus the periodic payments for the first year and the additional capital required to finance work in process and receivables, came near to being an intolerable burden.

It is of interest also to note that in the subject cases on this hearing the appellants bought the so-called Long Sault practice for precisely the amount of the previous one year's gross billings of the vendors, namely $5,100, and that in the case of the so-called Trenton practice purchase they paid a little less than the previous one year's gross billings. In doing so, the appellants appear in reaching their decision as to the price they were prepared to pay for the purchased goodwill, to have considered the formula used by others in the accounting profession when purchasing practices, as a sound one, or at least one that results in executed purchases and sales of practices.

The appeals are therefore dismissed with costs.