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TAX LAW FOR BUSINESS

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Taxing a goodwill

The value of a company's brand name, solid customer base, good customer relations, good employee relations and a good reputation of the business as a whole, is usually referred to as a goodwill. It is something that cannot be seen but adds value to the company's assets. Being an intangible asset, a goodwill may or may not be given corresponding financial values in financial statements (GR 125508). It is not separately identifiable from the rest of the assets of the company and is usually recognized only upon sale or disposition of the company.

As goodwill is related with the good reputation of the company's business as a whole, can we consider the sale of goodwill a sale of an ordinary asset subject to the imposition of ordinary income tax under Section 27 of the 1997 Tax Code?

In CTA EB Case 1257, the Court of Tax Appeals (CTA) en banc ruled in the negative. In this case, the CTA canceled the assessment issued by the Bureau of Internal Revenue against a taxpayer for alleged deficiency income tax due arising from the sale of a goodwill, pursuant to Section 27(A) of the 1997 Tax Code. The tax court ruled that a goodwill is not an ordinary asset

but a capital asset since (1) it is not included in stock in trade which would properly be included in the inventory at the close of the taxable year, (2) nor it is held primarily for sale to customers in the ordinary course of his trade or business, (3) nor it is a property used in the trade or business, of a character which is subject to the allowance for depreciation provided in subsection (f) of Section 34 of the National Internal Revenue Code, and (4) nor it is real property used in the trade or business.

Citing the old case of *WM H. Anderson vs. Juan Posadas Jr.*, GR 44100, September 22, 1938, the tax court ruled that if the goodwill, that is, the good reputation of the business is acquired in the course of its management and operation, it does form part of the capital with which it was established. It is an intangible moral profit, susceptible of valuation in money, acquired by the business by reason of the confidence reposed in it by the public, due to the efficiency and honesty shown by the manager and personnel thereof in conducting the same on account of the courtesy accorded its customers, which moral profit, once it is valued and used, becomes a part of the assets.

The gain or the loss is ordinary when the property sold or exchanged is not a capital asset. Goodwill is not an ordinary asset, as it is not among the exceptions under the definition of capital assets in Section 39(A)1 of the 1997 Tax Code. Hence, the sale of a goodwill is a sale of a capital asset subject to capital gains tax.

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