

# Accounting and Taxation Treatment of Goodwill in Portugal

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**Abstract:** The main goal of this paper is to understand the accounting and taxation treatment of goodwill in Portuguese jurisdiction. For this purpose, the Portuguese accounting and tax laws were investigated. For the accounting part, the Portuguese Accounting Standardization System (Sistema de Normalização Contabilística) was studied. Concerning tax issues, the Corporate Income Tax Law (Código do Imposto sobre o Rendimento das Pessoas Coletivas) was analyzed. The results show that there are some differences between accounting and taxation treatment. In accounting law, the goodwill acquired in a business combination is recognized as an intangible asset. It is amortized over ten years; therefore, it is an asset with indefinite useful life. In terms of tax law, the goodwill amortization is accepted, but only in the case of business combinations' acquirement. The tax legislator accepts the amortization as a tax cost for a twenty years period, unlike the accounting law (which determines a ten years period, as referred). Differences in treatment occur because these two areas have different goals. The main objective of accounting is the preparation of financial information that will be useful to make economic decisions. Whereas taxation seeks to collect tax revenue to help sustain public spending.

**Keywords:** intangibles assets, goodwill, Portuguese Accounting Standardization System, Portuguese corporate income tax

## 1. Framework

The discussion of "goodwill" started very early. Dicksee and Tillyard (1906) defined goodwill as "whatever adds value to a business by reason of situation, name, reputation, connection, introduction to old customers ...and there may be others which do not occur to me." The authors gave the example of "old customers will resort to the old place."

Goodwill represents an additional investment paid with the expectation of obtaining uneven returns on investment. There are several sources and reasons for these abnormal gains to occur (Courtis, 1983). In Wen and Moehrle (2016) goodwill "represents amounts paid more than the fair value of the identifiable net assets for a business acquisition." So, goodwill is an asset with expected future value, as well as tangible assets, such as inventory and property, plant and equipment.

Throughout the last century, the phenomenon of globalization has naturally produced technological innovations and advances in knowledge (Hughes, 1982). So, according to Cañibano, Garcia-Ayuso, and Sanchez (2000) goodwill is related to intangible investment, namely human resources, new technology, research and development, and advertising.

According to Johnson and Petrone (1998) the goodwill is an asset, not because it has a cost, but because it can contribute to future net cash inflows. The study also defends that this intangible asset is not a wearable asset because its value is not lost as equipment or a building. In that way, assets with indefinite useful life, as the goodwill, were subject to impairment tests and during a long time they were not amortized (Sun, 2016). This condition may contribute to greater volatility of results, always with the risk of applying inconsistent assumptions (Carvalho, Rodrigues, & Ferreira, 2016).

Goodwill is considered an important asset, and very often the most relevant intangible one in the balance sheet. So, academics continue to study this issue, which has resulted in the publishing of several studies in the last decades. The debate happens in both national and international jurisdictions (Cavalinhos, 2013; Chen & Zhang, 2017; Dicksee & Tillyard, 1906; EFRAG, 2016; Garcia, Katsuo, & van Mourik, 2018; "Going Concern Value Found Despite Absence of Goodwill," 1980; Górajski & Machowska, 2018; Guler, 2018; HENRIQUE ELIAS, 2011; Hughes, 1982; Jennings, Robinson, Thompson, & Duvall, 1993; Johansson, Hjelström, & Hellman, 2016; Johnson & Petrone, 1998; Mazzi, Slack, & Tsalavoutas, 2018; Ranjan, 2017; Ratiu & Tudor, 2013; Silva, 2017; Sun, 2016; Swanda, 1990; Victor, Tinta, Elena, & Ionel, 2012; Wen & Moehrle, 2016). However, it is possible to conclude that there are some studies about the issue, but the theme is unresearched in Portuguese accounting

and taxation area. It is important better known the accounting and taxation matters of goodwill of business combinations. Hence, the purpose of this paper is to study accounting and taxation treatment on business combinations' goodwill. That approach will be directed to the assets acquired as part of a business combination.

Wen and Moehrl (2016) concluded in their investigation that goodwill has represented, on average, up to 14–15% of the total assets of U.S. public firms, which reported non-zero goodwill on their financial position statements, in the period between 2005 and 2013.

Nevertheless, in 2014 internationally there were important changes. The IAS 38 - Intangible Assets was amended by the IASB, establishing the principle of amortization and in 2016 the depreciation and amortization methods recognized by the standard were clarified, taking effect from January of that year. In the national domain, and based on the process described above, the Accounting and Financial Reporting Standard 6 - Intangible Assets(NCRF 6) made the necessary alterations to reflect international changes.

Four sections compose this paper, first, the introduction, in which framing of the subject is done and where it is explained why it is important and updated to study this concept. Second, it is analyzed the goodwill concept. In the third section, an examination of the goodwill in Portuguese jurisdiction, accounting, and corporate income tax treatment is done, finally, in the fourth section, the conclusions.

## **2. Goodwill's Portuguese treatment**

### **2.1 In accounting standards**

The Portuguese rule that regulates the intangibles assets is the - *Norma de Contabilidade e de Relato Financeiro* 6 (NCRF 6). Paragraph 8 of this standard determines the concept of intangibles assets. They are non-monetary assets without physical substance that can be identifiable. Relating § 8 with § 10, it is possible to point its main characteristics, which are: 1) the nonexistence of physical substance, 2) to be identifiable, 3) to have the control over the resource, and finally, 4) the existence of future economic benefits.

Following item a) of the § 49 of the Portuguese Conceptual Framework - *Estrutura Conceptual* (EC) - an asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow into the entity.

The first characteristic, the nonexistence of physical substance, is a particular feature of this kind of assets. A. M. Rodrigues (2011) consider that this feature is not fundamental for the definition of intangibles, because some intangibles may have tangible substance, such as software (disk) or a certificate mentioning that a given patent has been granted.

The identifiability is studied on § § 11 and 12 of NCRF 6. In these terms, for an intangible asset to be identifiable, it is necessary to meet one of the two following assumptions. The first condition is to be separable (individually or jointly), meaning that it is possible for this asset to be separated or divided by the entity so that it can be sold, transferred, licensed, rented or exchanged. The second assumption is that it may result from contractual rights or other legal rights. It is not relevant if those rights are transferable or separable from the entity or other rights and obligations (Castro, Cunha, & Rodrigues, 2015).

According to § 13 of NCRF 6, the control is related to the power to obtain future economic benefits flowing from the resource, and the power to restrict others' access to those benefits. In the opinion of Cañibano et al. (2000), control is the entity's ability to exercise its rights (in other words, it is the possibility to claim rights or services legally) (Castro et al., 2015).

The accounting standard adds that the entity's ability to control future economic benefits is related to legal rights, referring explicitly to the copyrights as an example. It also mentions that a team of qualified personnel, technical talent, client portfolio, and market share cannot be recognized as intangible assets due to the lack of control by the entity.

Paragraph 17 of the NCRF 6 refers to the existence of future economic benefits (FEB). The accounting rule indicates that revenues from the sale of products or services, cost savings, or other benefits resulting from the

entity's use of the asset can be FEB's. It is the case of the use of intellectual property in a production process which can lead to the reduction of the costs of production.

For the initial recognition of the item as an intangible asset, the entity needs to demonstrate that the asset satisfies two conditions. First, it complies with the definition of an intangible asset, and second, it obeys to the recognition criteria set out in § 18 of the NCRF 6. The second requirement is clarified in § § 21 to 23. They declare that the recognition of the asset can only happen if, and only if: a) the expected future economic benefits that are attributable to the asset are likely to flow to the entity; b) that the cost of the asset can be reliably measured.

In the field of recognition, the standard establishes three "categories" of intangible assets, which are: those acquired separately, those acquired as part of a business combination and, finally, those generated internally.

Concerning goodwill acquired at a concentration of economic activities, the NCRF 6 in § 33 and following remit to *Norma de Contabilidade e de Relato Financeiro 14 - Concentrações de Atividades Empresariais*(NCRF 14).

This remission happens because the goodwill is entirely linked to the concentration of business activities. So, it must be articulated with the NCRF 14 and the IFRS 3.

Thus, it is possible to find the definition of "goodwill" on the § 9 of the NCRF 14. It determines the goodwill corresponds to future economic benefits resulting from assets that are not capable of being individually identified and separately recognized.

The § 44 of the NCRF14 refers that the acquired goodwill represents a payment made for an entity, in anticipation of future economic benefits of the assets that cannot be individually identified or separately recognized.

Business activity concentrations must use the purchase method for its recognition. This method considers the operation in the perspective of the acquirer (§§ 1 and 11 of the NCRF 14) and implies specific procedures.

Three different proceedings are required. First, acquiring company identification; second, measurement of the cost of the concentration of business and; finally, in the date of acquisition, the imputation of the operation's cost to the assets and liabilities acquired and contingent liabilities assumed (§ 12 NCRF 14).

According to §11 using this method implies the purchase of liquid assets and recognizes the assets, liabilities and contingent liabilities assumed. Also, those assets that have not previously been accounted for in the acquiree's individual accounts are recognized. The remainder, if there is any, corresponds to all other intangible assets, which cannot be autonomously recognized in the acquiring entity's accounts, and so it is identified as goodwill (Ana Maria Rodrigues, 2014, p. 236).

Under the §§ 25 and 28 of NCRF 14, the acquirer must, on the acquirement date, allocate the cost of a business combination by recognizing the identifiable assets, liabilities and contingent liabilities of the company that meet the recognition criteria of § 26. Thus, as a general rule, assets (other than intangible assets) and liabilities must comply with the definition of the asset and liability of Conceptual Framework of Portuguese Accounting Standards – *Sistema de Normalização Contabilística* (SNC). For all items (assets, liabilities and contingent liabilities) it is a condition that their fair value can be reliably measured. The measurement of identifiable assets and liabilities is carried at fair value on the date of acquisition.

The acquirer shall initially recognize the goodwill acquired in a business combination as an asset and measure the cost by b) § 43 of NCRF 14. In this context, goodwill is measured by the residual cost of the business combination after the recognition of identifiable assets, liabilities and contingent liabilities (Castro et al., 2015). Accordingly, if the acquired goodwill is greater than zero, it must be recognized as an asset, where its initial measurement is made at cost, as already mentioned.

Subsequent measurement of goodwill is made at cost less the accumulated amortization and impairment losses. This item should be amortized throughout its useful life when reliably estimated (§ 46 NCRF 14). If this reliable estimate cannot be achieved, goodwill shall be amortized over ten years, under § 105 of NCRF 6. The

acquirer must perform impairment tests whenever there is evidence that the asset may be impaired, according to NCRF 12 - Impairment of assets (§ 46 NCRF 14).

In the case of a low-price purchase, under § 48 to 50 of NCRF 14, the entity will face goodwill acquired less than zero, also designated as bad will. In this situation, two procedures are required. On the one hand, a reassessment of the process, which firstly measures the cost of the concentration and, secondly, the identification and measurement of the identifiable assets, liabilities and contingent liabilities of the acquiree recognized in the financial statements of the acquiring entity. On the other hand, it must recognize the remaining amount as deferred income and transfer the results to the extent that it is realized.

The internally generated Goodwill complies with § 46 to 48 of NCRF 6 and should not be recognized as an asset. The standard does not recognize this item as an asset because it considers that it is not an identifiable, entity-controlled resource that can be reliably measured at cost (§ 47).

## **2.2 Corporate income tax**

The Corporate Income Tax Code - *Código do Imposto Sobre o rendimento das Pessoas Colectivas* (CIRC) and Regulatory Decree no. 25/2009, of September 14 (DR 25/2009) constitute the legal precepts with greater relevance in the tax field when it comes to intangible assets. In the goodwill' tax treatment it is relevant to consider amortization and impairment losses.

The depreciation and amortization of elements of the asset subject to depreciation are considered as expenses, considering the intangibles assets as such (Hines, 2005). This assumption is assumed by taxation law, according to article 29, paragraph 1 a) do CIRC. Under the terms of no. 2 of the same legal disposition, assets that systematically suffer a loss of value resulting from their use or overtime are considered subject to depletion.

Article 16 of DR 25/2009 clarifies the tax treatment of intangibles, in its paragraph 1. It confirms the previous consideration and establishes that intangible assets are amortized when they are subject to depletion, in particular, because they are of limited duration. It is possible to consider the tax expense of the amortization of intangible assets with a finite useful life, by this idea.

The depletion is made having as basis the specific conditions. According to article 2, § 1, a) of DR 25/2009, the acquisition cost constitutes a depreciable amount of the items purchased to third parties to be taken into consideration. In the case of elements built or produced itself, the depreciable cost is the cost of production.

Article 45<sup>o</sup>-A of the CIRC provides that the cost of acquisition of the: a) industrial property elements (brands, licenses, production processes, models or other similar rights) acquired for the onerous title and not limited in time; and b) goodwill acquired in a business combination; are a tax expenditure. Since autonomously recognized in the individual accounts of the taxable person, by accounting standardization. The expenditure is accepted in equal parts, for the first 20 taxation periods, after the initial recognition. It should be noted that this provision was added to the CIRC through Law no. 2/2014, of January 16, which applies to taxation periods initiated or to tax events occurring since January 1, 2014.

Thus, it is possible to deduce that the provisions of this article apply only to intangibles acquired and that intangible assets generated internally are not included in this standard. On the other hand, it refers to intangibles with indefinite useful lives. Accordingly, the amortization of goodwill acquired in a business combination is accepted in equal parts for the first 20 tax periods after the initial recognition (Article 45-A, n. 1, b)).

Under paragraph 1 and h) of no. 2 of article 23 of the CIRC, impairment losses are recognized as tax expenses. It is necessary, however, to fulfill the criteria set by Article 31-B of the CIRC. This article addresses impairment losses on non-current assets. It determines that impairment losses on non-current assets arising from proven abnormal causes can be accepted as tax expenses. Some examples of these causes are disasters, the natural phenomena, the exceptionally fast technical innovations or significant changes, with an adverse effect, in the legal context. However, in order for this to be possible, the taxable person must obtain the approval of the Tax and Customs Authority, upon a duly substantiated statement (n. 2 article 31-B of the CIRC).

That means that for accounting expenses related to the impairment of intangible assets to be relevant for tax purposes, they have to observe two conditions. It is not enough that it results from exceptional causes, but also that the Tax Authority effectively accepts it.

A hypothetical example:

Considering the following assumptions concerning a company:

1. The company maintain over time the same revenues and expenses;
2. There is recognized acquired goodwill in the value of 100 000 monetary units (m.u.);
3. The goodwill is amortized for ten years (of year N until N+9), it means that the heading of depreciation and amortization has a recorded expense of 10 000 m.u. relative to goodwill;
4. In the eleventh economic period until twentieth year there is not an accounting record referring to the goodwill amortization, because the accounting rules determine that amortization in 10 years.
5. Tax rate – 30%

**Table 1:** Income Statement

<b>Tax Period</b>	<b>N</b>	<b>N+10</b>
Revenue	650 000	650 000
Other income	5 000	5 000
<b>Total revenues</b>	<b>655 000</b>	<b>655 000</b>
Raw material and consumables	480000	480000
Employee benefits expense	82000	82000
Depreciation and amortization	50 000	40 000
Impairment losses		
Other expenses	9500	9500
Finance cost	15000	15000
<b>Total expenses</b>	<b>636500</b>	<b>626500</b>
<b>Profit before tax</b>	<b>18 500</b>	<b>28 500</b>
Income tax expense	5550	8550
<b>Net profit</b>	<b>12 950</b>	<b>19 950</b>

The table 1 shows that if accounting and taxation rules were similar, the taxation of this company according with the assumed assumption would be less (5550) in the first ten years and higher (8550) in after the eleventh year. This situation happens because accounting standards determine that the goodwill is recognized in ten years.

**Table 2:** Tax corrections

<b>Tax corrections</b>			
<b>Profit before tax</b>		18500	28500
Amotization goodwill	➤	+10 000	
Amotization goodwill	➤	- 5000	➤ -5000
Impairment losses			
<b>Assessment profit</b>	➤	23500	23500
Income tax expense		7050	7050

Nevertheless, this study allows concluding about the differences in treatment between accounting and taxation law. The second determines the amortization of goodwill is made in twenty years and not in ten years according to accounting. This rule allows stabilizing the due corporate income tax over the twenty years.

Table 2 represents the tax corrections to determine the taxable income; for this, it is necessary to eliminate the negative effect of accounting amortization and correct for the accepted fiscal expense. So, in that case, it is necessary to add the accounting expense and to deduct the tax one.

Those rectifications are made in taxation statement. Thus, in this hypothetical example, the accounting amortization (10 000) must be added in the tax statement. The tax expense, corresponding to a one-twentieth part (of the goodwill cost) must be deducted in the same statement. Of the eleventh until the twentieth year, it is necessary recognizes a fiscal expense of 5000 m.u.

### **3. Discussion**

The difference in treatment between accounting and taxation is supported in the main objectives of each other. The article 3.2 of CIRC assumed an extensive notion of profit, according to patrimonial increment theory (Lal, 2012). It determines that the profit consists of the difference between the net assets in the beginning and the end of the tax period, although this profit is subject to some corrections according to CIRC dispositions.

In Portuguese corporate income tax, the determination of assessable profit recognizes the net profit as a basis to its determination, under the consideration of the article 17.1 of the CIRC. It means that taxation adopts partially the accounting profit determined under accounting rules, although subject to tax correction.

Accounting profit is calculated having as underlying the generally accepted accounting principles, the standards, and rules of accounting law (Berman, Knight, & Case, 2013). According to the IASB Conceptual Framework, the general purpose of corporate's accounts is "to provide financial information about the reporting entity that is useful to exist and potential investors, lenders, and other creditors in making decisions about providing resources to the entity." Financial reports should provide information about the entity's financial position, financial performance, cash flows and changes in financial position which are not caused by financial performance. They have as potential users the investors, employees, funders, lenders, clients, legal entities, and others (Melville, 2015).

The assessment profit follows the principles of tax law. It has as the main recipient the Tax Administration, and its goal is the tax revenue collection (Genschel & Schwarz, 2011; Nabais, 2015). In these terms, some accounting revenues and expenses cannot be recognized as tax incomes and tax expenses, if they do not obey to the fiscal purpose (Crane & Beale, 2012; Ferreira, 2000).

The non-recognition of some accounting expenses or incomes by the corporate income tax happens due to some reasons, such as the combating of fiscal erosion (Lal, 1981). In the case of the expenses, there are many situations that they are not recognized as such in fiscal terms. This fact is related to the fact that some of them are imputed to the result, allowing it is decrease and the reduction of the income tax, implied with this, lower revenue for the Tax Authority (Smith, 2015).

In those terms, the accounting profit can be subject to positive or negative fiscal corrections. They are positive corrections if the purpose is to eliminate the negative influence of the expense in the accounting profit, implying an increase of result subject to income taxation (Balachandran & Thothadri, 2012). They are negative corrections if it is expected the elimination of the positive influence in the tax basis, allowing the decrease of the profit that amortizations, provisions, and impairment losses are accounting expenses that, when they are recognized they decrease the accounting profit. When those expenses are considered by tax law, they also reduce the assessment profit. So, there are some cautions by the legislator to recognize that kind of accounting expenses (Crane & Beale, 2012; Hines, 2005).

In the case in study, the goodwill, only amortizations are considered in tax law but with some considerations. For accounting, determination goodwill is subject to amortization in 10 years, and in taxation law, it is allowed in 20 years. That has an impact on the tax basis, increasing the tax base in the first ten years and decreasing the same in the second ten years.

### **4. Conclusion**

The purpose of this paper is to study accounting and taxation treatment on business combinations' goodwill, in particular, the approach will be directed to the assets acquired as part of a business combination. The research allows the obtaining of some conclusions.

At the accounting level, if it is possible to reliably estimate the acquired goodwill useful life (finite useful life), it is subject to depletion according to the estimated duration. If it is not possible to reliably estimate its useful life, it is considered to be an asset with infinite useful life and should be amortized over ten years, per the provisions of § 105 of the NCRF 6. Internally generated goodwill is not recognized as an asset and is therefore not subjected to amortization or impairment losses.



Under the tax law, the cost of goodwill resulting from the concentration of economic activities is a tax expense. However, this expense is charged to the first twenty fiscal years after the initial recognition of goodwill.

There is a clear difference between accounting treatment and tax treatment. The cost should be fiscally charged in 20 years, double the time that is determined by the accounting standard. This difference could be related to the fact that the imputation of this cost in the results of the company does not exert too much influence on the accounts, differing that cost in time. For companies, this treatment's difference on the goodwill's accepted fiscal cost implies a deferral of tax savings from the first years to the detriment of recent years.

However, this research presents exploratory and descriptive research, because the paper only analyzed the accounting and tax issue's legal dispositions. Also, this paper only analyses the Portuguese's case study. Both represent significant limitations of the study.

As the future investigation, it would be interesting to cross these issues in other Europe member states, mainly to understand what how the fiscal legislator of that jurisdictions deals the goodwill's tax expense.

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## **Legislation**

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