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OMB Personal tax

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David Bowes provides an update on goodwill valuation

Key Points

What is the issue?

Using the facts of the Wildin case, this article explains what is goodwill, what types of goodwill could be transferred and what was the basis of valuation

What does it mean to me?

It was decided by the First-tier Tribunal judge that deducting net assets to find the goodwill value could result in anomalies, particularly if freehold properties are involved

What can I take away?

The decision seems to suggest that the attribution of greater value to intangibles might prove unhelpful after the changes to the treatment of goodwill and other intangibles announced in the chancellor's 2014 Autumn Statement

A valuation of the goodwill of a two-partner firm of chartered accountants was required in connection with the transfer of part of the business to a company. The goodwill value would have been material for three reasons:

1. capital gains tax (CGT) on the disposal of the business to the company;
2. disclosure on the company's balance sheet; and
3. amortisation of that goodwill giving rise to a corporation tax deduction.

The tax benefits would have applied to goodwill created since 2002 only. As a result of the changes introduced within the last twelve months, some of those benefits no longer apply, but this transfer took place in 2003.

The firm in question was a typical, small, local, general accounting practice with a standard mix of clients but no niche ones. The original dependence on the founder's substantial local contacts had long ceased and by 2003 the practice had grown, with a further partner, to 1,500 clients, 30 staff and substantially higher profitability.

On 1 April 2003 the senior partner transferred 84.85% of the business to the company, having, only days before, transferred 15.15% of the goodwill to the junior partner. The goodwill of the whole business had been valued at £1,650,000, of which the senior partner's share, 84.85%, would have seemingly been £1,400,000.

Given that a valuation of the goodwill, if any, in this business was required, three questions need to be answered:

- What precisely is goodwill?
- What type of goodwill, if any, was transferred on the incorporation of the business?
- What was the basis of valuation of any such goodwill?

What is goodwill?

Halsbury's Laws of England, fourth edition, states:

> 'The goodwill of a business is the whole advantage of the reputation and connection with customers together with the circumstances whether of habit or otherwise, which tend to make that connection permanent. It represents in connection with any business or business product the value of the attraction to the customers which the name and reputation possesses.'

International Valuation Standards 210 Intangible Assets at C11 defines goodwill as:

> '...any future economic benefit arising from a business, an interest in a business or from the use of a group of assets which is not separable'.

It is further stated:

> 'In general terms, the value of goodwill is the residual amount remaining after the values of all identifiable tangible, intangible and monetary assets, adjusted for actual or potential liabilities, have been deducted from the value of a business.'

Moreover, Lord Elton in the old case of *Crutwell v Lye* (1810) 1 Rose 123 said:

> 'Goodwill is nothing more than the possibility that the old customers will resort to the old place.'

However, the best known, and probably the classic definition, was given by Lord Justice McNaughton in *IRC v Muller and Co's Margarine* [1901] AC 217 as:

> '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 that distinguishes the old established business from a new business at its first start… Goodwill has no independent existence. It cannot subsist by itself. It must be attached to a business.'

Since the valuation in question was one for purposes that included tax, it would be helpful to understand the definition of goodwill for tax purposes. The *Capital Gains Tax Manual* at CG68010 adopts the *Halsbury's Laws* definition and the *IRC v Muller & Co* (Margarine) Ltd [1901] AC 217 quotation, but otherwise concentrates on characteristics including that goodwill is inseparable from the business in which it is generated and has its existence. CG68020 emphasises that, even though it may be comprised of various elements, even if the business consists of several trading activities or is carried on from several branches or outlets, for CGT purposes goodwill is a single asset.

Types of goodwill

Historically, goodwill has been regarded as a fungible asset that can be freely exchangeable or replaceable in whole or in part for another of like nature or kind, and growing or contracting as parts are acquired or disposed of. It can therefore be perceived as one of three kinds: free, personal or inherent.

Free goodwill

Free goodwill is attributable to the way the business is conducted. It reflects that trade is attracted by its reputation, and includes the benefits of contacts, contracts with customers, suppliers and employees, and any existing licences. Generally, free goodwill has been taken to be the difference in value between the entire business and its tangible assets.

Free goodwill had been regarded as having two types – separable or true, and adherent. For many years this was the view of HMRC, among others. Separable goodwill can be sold or transferred independently from the business and the premises and will therefore be disposed of when the business changes hands.

Personal goodwill

This is generated by the personality, special skills, contacts or reputation of a particular individual. It tends to be specific to or a characteristic of particular service industries, such as hairdressing. It may be difficult to sell the business unless the particular individual or individuals supposed to have the goodwill remain with it.

If these key personnel are bound to the business by an agreement that guarantees their future services, perhaps there is an asset that can be sold. If the transfer is by one such key person, responsible for the success of the business, there may be a restrictive covenant in the sale agreement to prevent that individual competing with the former business geographically or for a specified time.

In other cases, however, there may be a problem facing the individual who wishes to transfer such goodwill, say, on incorporation of a business. In the absence of any such agreement as above, the general position is that personal goodwill cannot be transferred to anyone or anything else. This is certainly HMRC's view in response to the claims made by sole traders and partners who attempt to sell their personal goodwill, such as medical practitioners.

Inherent goodwill

Inherent goodwill, sometimes known as 'site' goodwill, is theoretically generated by the location of the property from which the business is carried on rather than its operation. Such goodwill is an issue for a land valuer and will be dealt with in HMRC matters by the Valuation Office Agency (VOA).

It seems reasonable to suppose that, if there is an almost total dependence on a significant capital asset such as a mine, a quarry, or a gravel pit, any goodwill must attach to that asset. Accordingly, it would not be possible to sell inherent goodwill separately from it.

Goodwill in the accountancy practice

It would appear, subject to any excessive dependence on the partners, that any goodwill in the business in question would have been free goodwill and capable of transfer and valuation.

Goodwill valuation methodologies

For CGT, tax is assessed by reference to the market value of the particular asset disposed of, namely what it would realise on sale in the open market. What valuation methodology would be likely to apply to this business, or might there be more than one?

For trading businesses the methodologies most likely to be adopted are one of the following:

- capitalisation of profits; or
- trade/industry customs or rule of thumb.

However, in this particular case there was a further possibility, which was the use of transactional information. At the valuation date in question the so-called ‘consolidators’ – companies listed either on the stock market or on the alternative investment market (AIM) and financed by external investors – had been seeking to acquire accounting practices, paying multiples of between 2.5 and 3.5 times turnover for them in 2003. Would these transactions provide a basis for valuation?

Industry customs

Regard must be had in any market valuation to market practices. So where businesses are sold in the real world by reference to established practices, consideration must be given to adoption of the same for valuation of such businesses and their goodwill.

Many industries have particular methodologies or ‘rules of thumb’ that apply on sales of businesses. They tend to be based on multiples or proportions of recurring income. An understanding of the underlying cost base of the business will enable the acquirers to appreciate the profits they can expect to generate from a given turnover. In some instances such methodologies may be based on a proportion of assets rather than income.

As already stated, the firm in question was an accounting practice, and there is of course a long-standing methodology widely used for the valuation of such firms, namely a multiple of recurring fees. However, the firm was very profitable so it might have been better to capitalise profits, and then of course there were the consolidators to consider. Therefore:

- What was the most suitable methodology?
- If the valuation were to be based on turnover/fees, what would be the appropriate level of fees to be adopted? And what was the appropriate multiple to be adopted?
- Should the tangible assets of the business be deducted from the value arrived at above in order to arrive at the value of goodwill?

As stated, at about the valuation date the consolidators had been acquiring accounting practices for multiples of between 2.5 and 3.5 times’ turnover. However, the consolidators in question, which at the time were few, may have been special purchasers and there was no indication that they were interested in acquiring this business. Nor was there evidence that transactions in which the consolidators were not involved were being completed at similar multiples. They were certainly in the market, but not setting the standard for all transactions. It therefore appeared that there was no case to be made for adoption of anything approaching the multiples the consolidators paid.

On the premise of adopting the long-established methodology of using turnover/fees to provide the valuation basis, what level of fees would be appropriate for use in the calculation? Would it be reasonable to use those for the most recent year, or perhaps an average of a longer period? Turnover of the business for the most recent year had been £1,003,828, whereas a three-year average produced a figure of £1,056,540. In the event, it was felt that the three-year average provided the better approximation for valuation purposes.

Assuming that the turnover/fees methodology would apply, what multiple would be suitable for use in the calculation? There had been suggestions that it should be between one and two. On that basis, it appeared that it would be reasonable to adopt the mid-point of 1.5. The application of the multiple of 1.5 thus produced a total value of £1,548,810.

Value of the business, or value of the goodwill?

So far, so good. However, it has long been held to be the case, in relation to other businesses, that goodwill is the difference between the capitalised earnings value of the business and the tangible assets. Is that also the position for a business such as this, and did that mean that the tangible assets would have to be deducted from the £1,548,810?

In a website publication, *Accountancy Practice Mergers and Acquisitions*, Jeremy Kitchin, it states:

> '...goodwill represents the difference between the overall business valuation, arrived at on the foregoing basis (being the capitalised earnings one) and the aggregate book value of the individual net assets carried in the balance sheet'.

One presumption that follows from this conventional approach is that the business has a fixed value. The amount of this that relates to goodwill depends on the quantum of the tangible assets. The greater value they have, the less can be attributed to goodwill.

Some, including this author, have long struggled with this logic. Why should identical businesses with the same level of recurring fees have different values for goodwill, merely because one owns, let us say, a valuable freehold property whereas the other does not? And is the value of the tangible assets relevant at all in relation to a business such as this where the fees could be sold separately from the practice? Conceptually, there is an element of illogicality in assumptions such as these, and in *Wildin v HMRC* [2014] UKFTT 459 (TC), the First-tier Tribunal (FTT) agreed.

The judge decided that deducting net assets to find the goodwill value could result in anomalies particularly if freehold properties are involved. Therefore, taking the value of the fees as the value of the goodwill was a reasonable method to arrive at a valuation for CGT purposes for professional firms. The figure of £1,548,810 was accordingly accepted by the tribunal as the value of the goodwill of the business.

Where are we now? In the melting pot

This decision would appear to be at odds with the long-held view of HMRC, who were seemingly arguing at the tribunal:

> '...all other things being equal, a business with larger net assets will have a lower value of goodwill than a business with a smaller value for net assets...'

For SDLT apportionment purposes, it held:

'The value of the goodwill, reflecting its value when sold with the property, is the sale price paid for the business as a going concern less the value of all the tangible assets as an operational entity.' (*HMRC Practice Note – Apportioning the price paid for a business transferred as a going concern*)

The tribunal decision may, in some respects, be good news, perhaps even causing HMRC to reconsider its position and result in greater value being attributed to goodwill. However, this being a tribunal decision, it does not set a precedent. But the perceived wisdom since the changes to the treatment of goodwill and other intangibles referred to earlier seems to be that the preference in future may be for less rather than more. If that proves to be correct, this decision, which seems to support the attribution of greater value to intangibles, might prove unhelpful in the long run.