The goodwill game

CHRIS HART explains the current state of play concerning the valuation of goodwill for SDLT and capital gains tax purposes.

As will be generally known, in the autumn of 2008 the Valuation Office Agency (VOA) entered into a consultation with the Royal Institution of Chartered Surveyors (RICS) over a draft practice note entitled Apportioning the Price Paid for a Business Transferred as a Going Concern (www.lexisurl.com/Zfam3). This document related to the separation of tangible and intangible assets in what valuers refer to as trade-related properties.

As a brief reminder for those not personally involved in such valuations, the most common issue is the separation of the goodwill and property elements on the acquisition or disposal of a business. For example, a care home may attract business by virtue of its location and the manner in which the business is operated. Historically, the former goodwill might be termed ‘inherent’ or adherent. The inherent goodwill being the increased value of the property over and above its pure ‘bricks and mortar’ value by virtue of its location; the adherent being, say, the licenses, etc. allowing a property to be used for a specific business purpose. ‘Free’ or personal goodwill might be the owner’s name and personal reputation.

In the above-mentioned practice note, HMRC now state that ‘These subdivisions are no longer considered helpful as they tend to cause confusion. ‘Inherent’ and ‘adherent’ goodwill are not really goodwill at all as they form part of the value of the property asset.’ The note moves on to suggest that the benefit of contracts with customers, staff and suppliers will affect goodwill valuations. In the case of a pub with few contracts the value of goodwill may be nominal, but returning to our care home, using fully-qualified staff, and where finding new residents and staff is likely to be more difficult, the element of goodwill may be more substantial.

HMRC’s approach outlined in the practice note, which the VOA subsequently described as ‘a unique, different basis of valuation’, was rejected in trenchant terms by the RICS, and is not generally considered to have any remaining credibility, although it appears that the VOA find this hard to understand or accept. The chairman of the RICS Taxation Policy Panel, Chris Doyle, has now declared debate on this particular approach closed, although alternative approaches may still be considered.

The recent issue of the overview note, as a frontispiece to the already published HMRC notes, does not, unfortunately change the situation. So where does this leave us now?

As part of its efforts to promote helpful consultation, the RICS made contacts with a range of external bodies, specialist practitioners and, within the RICS, across a range of skills and disciplines. Whilst the VOA concepts were without exception rejected, a significant level of consensus was reached and there is a clear way forward if HMRC, together with the VOA, wish to explore it.

Externally, the main bodies the RICS consulted with were the Chartered Institute of Taxation, the Stamp Taxes Practitioners Group and the Society of Shares and Business Valuers. Subsequently, a letter of support for the RICS position has been received from the Law Society of Scotland.

The underlying principles

A number of underlying principles emerged.

First, the identification of goodwill as an intangible asset for capital gains tax purposes purposes and apportionments of composite transactions to isolate the chargeable interest, and with it chargeable consideration, for stamp duty land tax (SDLT) purposes, were similar, but not identical.

KEY POINTS

- Background to recent consultation on business valuation.
- The underlying principles of the valuation process.
- Case law and ‘just and reasonable’ apportionment.
- Valuing the constituent parts of the business.
- Opening the door to further debate with HMRC.
Secondly, it was not appropriate for a taxing authority to rule on the way in which the value of a business was arrived at. This was a matter for the private sector and the requirements of the market.

Thirdly, there was no legal justification to attempt to apply valuation methodology to particular trades in ways which created differential taxation consequences.

Finally, it would be helpful, for the purposes of self assessment, to identify a generally agreed approach suitable for all categories of property asset where apportionments were required for taxation purposes, and to create a situation where lawyers and accountants could instruct valuers to provide them with the necessary opinions of value.

It was also agreed that the specific problems which emanate from legislation contained in FA 2002 for capital gains tax and FA 2003 for SDLT required resolution as a matter of urgency. There are too many open enquiries where little or no progress is being made, mainly because of a search for an apparently HMRC favourable approach.

### The valuation of goodwill is a specialised and complex business.

Finding a practical solution

The question, therefore, was whether a practical solution could be found. For both capital gains tax and SDLT, the term ‘just and reasonable apportionment’ is used in TCGA 1992, s 52(4) and FA 2002, Sch 29 para 72(5) for capital gains tax and in FA 2004, Sch 4 para 4(1) for SDLT purposes. So what does this term mean?

In taxation terms, it means just and reasonable for both the taxing authority and the taxpayer. It should seek to achieve a balance between the parties, without unduly favouring either.

In a valuation context, the originating case is generally considered to be *Salts v Battersby* [1916] 2 KB 155, where Darling J stated that the correct approach in that case was to be value, not area based. A more recent case involving apportionment was *Bostock v Totham* [1997] STC 764, where it was said that the approach adopted did not seek to apply the principles of a value-based ratable apportionment.

Ratable apportionment entails valuing the component parts to a composite transaction individually and then applying them in a formula to isolate the particular element required. See also HMRC’s *Tax Bulletin 24* issued following *Gray & Others (Lady Fox’s Executors) v CIR* [1994] STC 360.

An alternative method is that of deduction, sometimes referred to as a ‘stripping back approach’. As in the case of *Findlay’s Trustees v CIR* [1938] 22 ATC 437, in order to identify ‘goodwill’, it was suggested that the values of the tangible assets should be deducted from the capitalised value of the business profits to leave a residue, said in that case to comprise the element of goodwill.

### Just and reasonable

The underlying principle is, however, the ‘just and reasonable’ requirement, so either ratable apportionment or deduction have equal application. The SDLT requirement is to separate chargeable consideration from other matters (FA 2003, Sch 4 para 4(1)). There is no specific requirement to identify ‘goodwill’ or to quantify it; indeed goodwill is not mentioned anywhere in the SDLT legislation. I will return to the concepts of inherent and adherent goodwill in due course.

The capital gains tax requirement is to exclude certain tangible assets, identified in FA 2002, Sch 29 para 73, from the value of ‘goodwill’ as defined as an intangible fixed asset in Sch 29 para 4. Basically, the excluded assets comprise interests in land and tangible movable property, the bricks and mortar and the chattels.

In accounting terms, the separation of the excluded assets is achieved by identifying a fair return on the tangible assets, which may or may not be reflected by those assets’ capital values. The definition, or meaning, of goodwill in Sch 29 para 4 is that which ‘it has for accounting purposes’.

### The Red Book

The valuation of goodwill is a specialised and complex business. There is no property-based concept of ‘goodwill’ as an intangible asset. The nearest the RICS *Valuation Standards Manual* (‘The Red Book’) comes to it is in GN1 where it refers to ‘transferable goodwill, that intangible asset that arises as a result of property specific name and reputation, customer patronage and similar factors, which generate economic benefits. It is inherent to the specialised trading property and will transfer to a new owner on sale’.

It goes on to say that ‘in previous RICS guidance transferable goodwill has also been referred to as inherent goodwill. In the valuation context, these terms are identical. Other professional advisers may use other definitions of types of goodwill, such as “free goodwill”, which do not have any bearing on the valuation of property. In relation to a trade-related property valuation, goodwill is either capable of transfer with the property interest or it is not’. GN1 also considers the concept of personal goodwill, in a valuation context. It must be appreciated that GN1 is an international valuation standard that has two valuation bases; one is of a fully-equipped operational entity, and the other is of an empty property. In both cases the valuations have regard to ‘trading potential’ which is based on the concept of ‘fair maintainable trade’. Whilst proper regard is had to all available accounting information, it is not the actual trade which is valued, but that which might be achieved by a ‘reasonably efficient operator’. Therefore as GN1 states ‘this guidance note does not apply to going concern or business valuations.

Therefore, whilst GN1 is a balanced and practical basis for valuing ‘trade-related property’, it is not an immediately useful valuation ‘basis’ in the context of apportionments for SDLT or capital gains tax purposes, although some of the valuation methodology generally adopted in preparing GN1 valuations, may well be.
Separate goodwill

Clearly a property asset and goodwill, or the value of the activities of the people in the property asset, may be separate assets with their own intrinsic values. *Halsbury’s Laws of England* (4th edition, Vol 35, reissue, para 1208) states that ‘goodwill is not a thing which can be separated and dealt with apart from the business out of which it arises, but it may be dealt with as an entity separate from the particular premises in which that business has been carried on’.

In 2007, the Court of Appeal, in *Condliffe v Sheingold* [2007] EWCA Civ 1043, overturned the decision of the lower court and said that the judge of the first instance ‘appears to have overlooked the fact that the goodwill related to the business, and that it could be separated from the lease and be the subject of separate ownership’. This case related to the residue of a three-year lease of premises used as a restaurant where the operating company went into liquidation.

In September 2008, HMRC issued a revision to their *Capital Gains Manual* which stated, at CG68010, ‘goodwill is inseparable from the business in which it is generated and has its existence, see CG68030. When a business is disposed of as a going concern, any goodwill attributable to the business will be transferred to the new operator’. This is a standpoint which was accepted by the RICS and those the RICS consulted.

Constituent parts

It appears that there is clear authority for the proposal that within the value achieved for a going concern there are a number of constituent parts which may be ascribed different and independent values. For SDLT purposes, we must separate the value of the chargeable interest from other matters which include chattels and any value ascribable to the business or business activities of the occupants of the property. For capital gains tax purposes, we must exclude tangible assets, comprising the property asset and chattels, from the residue, which will include any elements of goodwill and the values of any other intangible assets present, for example brand names.

The first issue is what should one include in the value of the property, and how should that value be ascertained? Historically, much has been made of inherent and adherent goodwill. It is arguable that these elements should not be called goodwill because they are part of the tangible asset and embedded in its value. Inherent goodwill reflects the value brought to the property by its location and adherent goodwill reflects its adaptation for a purpose. Whilst these elements may be more pronounced in a trade-related property such as a pub, they are present in all categories of property assets to a greater or lesser degree.

In *Whiteman Smith Motor Company v Chaplin* CA [1934] 2 KB 35 (the ‘zoological’ case), it was held that any inherent and adherent goodwill would be reflected in the property’s rental value. This was a tenant’s compensation case under the then existing landlord and tenant legislation. Therefore, the ascertainment of a property’s rental value will include all ‘embedded goodwill’; additionally, most commercial properties are valued with regard to a capitalisation of their actual or notional rental values, unless valued as fully-equipped operational entities.

Valuation methods

From the perspective of the capital gains tax ‘exclusion’ of tangible assets, a rental value may be used as a deduction from the accounts to leave a net residue, to which to apply the appropriate valuation techniques. In the Lands Tribunal case of *Optical Express (Southern) Ltd v Birmingham City Council* ACQ/109/2002, where the property concerned was leasehold with a passing rent, methods of valuing what was referred to as ‘goodwill’ in the context of compulsory purchase legislation were explored. These include a price/earnings multiplier, a discounted cash flow approach, and a multiple of maintainable earnings before interest, tax, depreciation and amortisation [EBITDA]. The Shares and Assets valuation group of HMRC have, generally, historically favoured the PE ratio approach although the ‘market’ is moving to more sophisticated techniques.

This issue is also being considered in detail elsewhere.

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The International Valuation Standards Council has recently issued a revised disclosure draft of Guidance Note 4, *Valuation of Intangible Assets*, and a proposed International Valuation Guidance Note 16, *Valuation of Intangible Assets for IFRS Reporting Purposes*. Both of which will have significant relevance to the ongoing UK debate.

A rental-based approach

A consensus has been reached within the RICS and amongst those consulted that a rental-based approach may produce the most appropriate solution, both to the ascertainment of chargeable consideration for SDLT purposes and to the isolation of the ‘residual’ element after the exclusion of the tangible assets for capital gains tax purposes. However, the rental or notional rental value would have two specific uses within the calculations; first to ascertain the capital value of the asset by capitalisation at an appropriate rate and secondly to ascertain the value of any element of goodwill by using a rental value to identify a fair return on the assets.

Rental values have two other practical advantages. First, there are approved methods and guidance in relation to all types and categories of property, and secondly there is plenty of market evidence to draw on.

There are a number of assumptions to be agreed in relation to the ascertainment of rental value and the appropriate ways in which it should be capitalised. Similarly, there needs to be
a relatively simplistic approach to the ‘valuation’ of the ‘other matters’ element for SDLT purposes, and a more complex approach adopted for the valuation of ‘goodwill’ for capital gains tax purposes. However, a way forward is clearly identifiable. Even though it requires each case to be treated on its own merits, it allows proper consideration to the value ascribable to the actual accounts of the going concern subject of the transaction. With regard to the valuation of the ‘chattels’, it would seem sensible to adopt their tax written down values as brought into account for capital allowances purposes.

Both capital gains tax and SDLT share the same basis of valuation. SDLT, at FA 2003, s 118, adopts the definitions in TCGA 1992, ss 272 to 274. These, as defined in The Red Book at UK GN 3, adopt the concept of the hypothetical transaction, between a hypothetical vendor and a hypothetical purchaser and its accompanying assumptions. This basis of valuation for taxation purposes, was agreed between the RICS, and others, and HMRC in 2000 as the only appropriate basis of valuation for taxation purposes.

Conclusion

The door to further discussion and consultation is still open from the RICS standpoint, but this is not solely a valuation matter. As Charles Smith said in his article ‘Chalk and Cheese’ (Taxation, 6 November 2008, page 502), ‘Whichever way you look at it, goodwill is a people and not a land thing, and the distinction between land and goodwill is a legal and not a valuation matter’. It is, I would suggest, in reality a legal, valuation and accounting matter and the RICS and those bodies mentioned at the beginning of this article are interested in further debate with HMRC to try and bring this issue to a ‘just and reasonable’ resolution. There are certain ‘misunderstandings and misconceptions’ still to be overcome, but with goodwill on both sides, this is readily achievable.

Chris Hart FRICS is vice-chairman of the RICS Taxation Policy Panel.