The sale of trading/practice goodwill at market value to a new company is a legitimate transaction. Indeed, since the sale is normally being made to a ‘connected party’, s17, Taxation of Chargeable Gains Act 1992 (TCGA 1992), deems the transaction to take place at its market value for CGT purposes and it was not so long ago that taxpayers looked to defer this gain rather than pay the CGT.

Nevertheless, it is perhaps not surprising that (in recent years) HMRC has begun to look at the supporting goodwill valuations more closely to ensure they stack-up commercially. Indeed, many accountants receive letters from HMRC’s Shares and Assets Valuation (SAV) office, which run to many pages asking all sorts of wide-ranging questions relating to the economics and underlying profitability of the business, etc.

The recent case of Wildin v HMRC [2014] UKFTT 459 (TC), which is discussed below, also illustrates the tenacity of HMRC’s SAV office when dealing with goodwill valuations on incorporations, especially in relation to professional firms.

PERSONAL AND BUSINESS GOODWILL

In Tax Bulletin 76, April 2005, HMRC sought to draw a distinction between personal and business goodwill. HMRC insists that personal goodwill, which relates to the personal skills, attributes and personality of a particular individual, is not capable of

A MATTER OF GOODWILL

After the Wildin case, Peter Rayney says the value of goodwill must be commercially sustainable

Over the last decade or so, many tax advisers and accountants have had to dust down their goodwill valuation texts. This is largely due to the significant increase in the incorporation of existing businesses and professional partnerships, such as accountants, lawyers, dentists and so on. Furthermore, the vast majority of these incorporations tend to be structured as an asset sale at market value.

This sale structure has significant tax advantages. The proprietor/partner sells their goodwill to the (new) company at its market value (along with the net tangible assets). In the majority of cases, the company has little or no opening cash funds, so the consideration value of the transferred assets is normally credited to the director’s loan account.

However, since the capital gain on the goodwill would invariably qualify for entrepreneurs’ relief (ER), it will only be taxed at the beneficial 10% ER capital gains tax (CGT) rate. The proprietor/partner therefore often creates a substantial credit balance on their loan account for the sale value of the goodwill at an effective tax cost of 10%. They incur no further personal tax charge on the repayment of their loan account, so this becomes a very efficient method of extracting income from the company. Indeed, there will be a further tax advantage where the original sole trader/partnership firm had started trading after March 2002. In such cases, the corporate intangibles regime permits the company to deduct its annual goodwill amortisation for tax purposes.

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being transferred to the company. Personal goodwill is only likely to be found where the business depends on the special skills and personality of the sole trader, but the same business may have some other goodwill value, which is capable of being transferred.

On the other hand, free business goodwill normally derives from a business’s brand or good name, reputation, employee expertise, customers, client base and so on, and is capable of being sold for value.

In recent years, HMRC has been particularly resistant to accepting the existence of free goodwill where groups or partnerships of medical consultants ‘incorporate’ their separate private practices. HMRC’s typical challenge is that a company cannot carry on a profession. Furthermore, perhaps surprisingly, HMRC has argued that ‘where a company that employs professionals to exercise their profession as employees of the company, it has not succeeded to the practice previously carried on by the professionals in their own right’.

One final potential trap is the sale of occupational income provisions in chapter 4, part 13, Income Tax Act 2007 (ITA 2007). Under these anti-avoidance provisions, HMRC has the ability to tax capital proceeds as income.

Broadly, the rules can be triggered where there are arrangements to exploit an individual’s earnings capacity in the course of their occupation with the view to avoiding income tax (s773(2) ITA 2007). They should not therefore apply to commercially driven transactions.

Furthermore, the vast majority of incorporation-based transactions should also be exempted from this potential income tax charge under the ‘sale of going concerns’ exemption in s784, ITA 2007. Notably, HMRC will seek to apply these rules to entertainers and sports people who sell ‘royalty’ income streams, etc, to connected companies.

AGREEMENT VALUATIONS WITH SAV

SAV clearly seek to establish that goodwill valuations used for incorporation sales are not ‘excessive’. Thus, when planning the incorporation of a particular business, the golden rule is to make sure that the goodwill value used is reasonable and defensible. There is nothing worse than starting negotiations with SAV on the back foot because of an initial over-zealous or fanciful valuation.

It is therefore sensible to arrange for a carefully considered goodwill valuation report to support the sale value used.

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Many proprietors/partners may wish to obtain certainty on their goodwill valuations when they submit their tax returns by using SAV’s post-transaction valuation check service. This would entail submitting a request to SAV on form CG34 for the goodwill value to be agreed shortly after the incorporation has been completed. This ought to give sufficient time to agree the valuation for CGT purposes before the 31 January filing date.

However, the SAV’s post-transaction valuation procedure is not compulsory and some clients

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**GOODWILL VALUATION (CAPITALISED EARNINGS BASIS)**

<table>
<thead>
<tr>
<th>Description</th>
<th>£’000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessment of maintainable profits</td>
<td>680</td>
</tr>
<tr>
<td>Commercial salaries for two partners (including employers’ NIC)</td>
<td>(200)</td>
</tr>
<tr>
<td>Economic rental charge</td>
<td>(50)</td>
</tr>
<tr>
<td>Interest on capital (say)</td>
<td>(30)</td>
</tr>
<tr>
<td>Adjusted pre-tax profit</td>
<td>400</td>
</tr>
<tr>
<td>Less: Corporation tax charge @ 20%</td>
<td>(80)</td>
</tr>
<tr>
<td>Maintainable earnings</td>
<td>320</td>
</tr>
<tr>
<td>Capitalised earnings</td>
<td>1,280</td>
</tr>
<tr>
<td>£320,000 x multiple of 4</td>
<td>1,280</td>
</tr>
<tr>
<td>Less: Net asset value (excluding property held personally by partners)</td>
<td>(570)</td>
</tr>
<tr>
<td>Value of goodwill</td>
<td>710</td>
</tr>
<tr>
<td>Rounded to</td>
<td>700</td>
</tr>
</tbody>
</table>
often prefer to deal with the goodwill valuation when their tax returns are submitted.

DEALING WITH EXCESSIVE GOODWILL
Where HMRC succeeds in demonstrating that the proprietor or partner has overvalued the goodwill, i.e., the valuation is ‘excessive’, there are likely to be two possible outcomes:

- Strictly, the ‘excess’ amount should be treated as a taxable distribution from the company. This is because the proprietor/partner would have credited their director’s loan account for an amount exceeding the value of the goodwill. Since the amount would normally be received by the proprietor/partner in their capacity as a shareholder of the company, the excess amount is taxed as a distribution under s1000 CTA 2010.

In most cases, the shareholder would generally suffer a 25% and/or 30.6% effective tax rate on the net distribution (depending on their marginal tax bracket).

HMRC will seek to apply the strict ‘distribution’ treatment where it considers that the goodwill was deliberately over-valued or there was intentional tax avoidance. It is also likely that HMRC will seek penalties in such cases on the basis that there has been a failure to take reasonable care (or in certain cases, HMRC might be able to sustain that the overvaluation was a deliberate error).

- As a general rule, where it can be shown there was no intention to value goodwill excessively and reasonable efforts were made to ensure that the transfer was made at market value (for example, by using a proper professional valuation), HMRC will generally permit the distribution to be unravelled (see Company Tax Manual CT1529a). Further protection can also be obtained by building an appropriate provision in the ‘incorporation’ sale contract to sell the goodwill ‘at the relevant amount or such value as may ultimately be agreed with HMRC’s SAV’ – this is often referred to as a sale consideration ‘adjuster clause’).

Therefore, where a properly considered goodwill valuation report has been prepared, HMRC will normally be prepared to ‘unwind’ the apparent distribution. This means that the ‘excess’ value would be debited to the owner-manager’s loan account (with a corresponding ‘credit’ being made to the goodwill ‘asset’ account). Of course, if significant loan account repayments have already been made, this adjustment may cause the loan account to become overdrawn. The benefit of having an interest free overdrawn loan account is likely to be treated as taxable benefit (under s175 ITEPA 2003). Furthermore, the company would also suffer a 25% tax charge under s455 CTA 2010 on any amount remaining outstanding more than nine months after its year end.

MAIN VALUATION TECHNIQUES
Many established trading businesses are often valued by reference to a ‘capitalisation’ of the firm’s earnings using maintainable profits and a suitable profit multiple. Once this capitalised figure has been determined, the firm’s current net (tangible) assets are then deducted to arrive at the goodwill value.

The goodwill valuation exercise requires a vigorous assessment of the maintainable profits, normally using historic profits as a guide but also taking into account projected profits (based on reasonable assumptions). A common approach is to take the firm’s accounts for (say) the past three years and make appropriate adjustments for income/expenditure of a non-recurring nature.

Adjustment is also made for expenditure that is not reflected in the accounts but would be a normal business expense going forward (eg, sole trader’s/partner’s commercial salaries, interest on capital, rent payable for personally owned offices, etc).

Other factors that will influence the valuation include the reputation of the firm and its ability to attract new business, the customer/client profile and whether any customers/clients generate significant recurring fee income and so on. The accounting profits should also be adjusted for taxation (using company tax rates).

Under this valuation model, the goodwill value is arrived at as follows:

SAV often agrees the value of smaller businesses as a multiple (often two to three) of their maintainable (pre-tax) profits.
An example of a typical goodwill valuation for a small marketing consultancy firm is illustrated in figure 1. This valuation approach has support under generally accepted accounting principles, which broadly arrive at the goodwill value on a business acquisition by deducting the fair value of the net tangible assets from the sale price (ie, business value). However, in many business sectors, business and goodwill valuations are frequently based on accepted benchmarks. This practice has largely grown on the basis that businesses operating in the relevant sector will have similar cost bases. For example, many professional service firms are now often sold on the basis of a multiple of gross recurring fees or maintainable fee income.

**WILDIN VALUATION**

This practice has recently been highlighted in the Wildin case. A summary of the key facts and the First Tier Tribunal’s (FTT) decision is provided in figure 2a. The FTT acknowledged that valuation is an art not a science and that its job was ‘to ascertain the best method for valuing goodwill for this taxpayer on these facts and on the basis that no method will provide a perfect answer’.

The tribunal therefore felt able to place great reliance on the empirical evidence and concluded that the firm’s goodwill should simply be calculated by reference to a multiple of its gross recurring fees, since often accountancy practices change hands on this basis. HMRC’s argument (based on often accepted authorities) that the firm’s net assets should reduce the fee multiple-valuation was therefore rejected.

**OTHER METHODS**

There are, of course, a number of other approaches. In practice, SAV often agree the value of smaller businesses as a multiple (often two to three) of their maintainable (pre-tax) profits. There is also case law authority for the so-called super profits method. Although rarely used nowadays, this calculation looks at the number of years’ worth (typically two to three) of super profits generated by the business. The ‘super profit’ is derived as follows:

\[
\text{Actual maintainable profits of the business (allowing for management salaries, etc)} = \text{£ X}
\]

\[
\text{Return on the capital invested above the normal investment return (say 5% above base rate)} = \text{£ (X)}
\]

\[
\text{Super profit} = \text{£ X}
\]

While there are a number of accepted approaches to valuing goodwill, they should (in theory) arrive at a similar valuation. Many professional valuers tend to value the goodwill using more than one approach which provides a useful cross-check. As a further ‘sense check’, I always like to ask the owner how much they would (realistically) be prepared to sell their business for.