

Was it a distribution? (Lecture B1412 – 13.03 minutes)

Smith and Corbett v HMRC (2023) is a recent First Tier Tribunal decision dealing with the question of whether a company had made an income distribution to two taxpayers.

HMRC considered that the company – Simpsons Independent Financial Advisers Ltd (SIFA) – had made a distribution to the appellants which met the definition of that term in s.1000 CTA 2010 and which was therefore assessable to income tax under s.383 ITTOIA 2005. The distribution was said to have been in the form of goodwill which had been credited to the individuals' capital accounts in Simpsons Wealth Management LLP (SWM).

Background

SIFA was incorporated on 29 June 1999 on which date Mr Corbett was appointed a director of the company. The other appellant – Mr Smith – became a director on 1 January 2006. The two individuals had known each other for several years and, in 1995, Mr Smith started working for Mr Corbett who, at that time, operated as an independent financial services sole trader. There was no written evidence as to the terms of Mr Smith's employment when he commenced this job, but the judges accepted the evidence of both parties that Mr Smith's clients 'belonged' to him.

Indeed, they explained the position as follows:

'Whilst employed, it was expected that Mr Smith would cultivate and nurture professional relationships with the clients with whom he had historically worked and develop new relationships, usually by word of mouth from existing relationships. The propensity for (initially Mr Corbett and subsequently SIFA) to be able to derive income from those clients was founded in the relationship between the client and Mr Smith and his personal reputation with them, and not as a consequence of the reputation of his employer. As such, we find that, despite there being no formal written terms of employment for the period from 1995 – 1999, it was accepted and agreed between Mr Corbett and Mr Smith that, should Mr Smith cease employment with Mr Corbett, his clients would follow him together with the ability to obtain an income from advice provided to them. For the period from 1999, when the (sole trader business) was incorporated into SIFA, we find that there was a similar understanding/expectation between SIFA and Mr Smith.'

In due course, Mr Smith's employment arrangements were formalised with SIFA through a written contract. This was dated 24 June 2002 and, as mentioned above, Mr Smith became a director of SIFA on 1 January 2006.

The judges commented:

'We infer (though there was no direct evidence) that the terms of Mr Smith's employment which subsisted from 2002 continued whilst he was a director and accordingly find that the expectation regarding the ability to port clients on a change of employer continued.'

The same regime applied to Mr Corbett and no value was ever attributed to Mr Corbett's clients in the SIFA accounts.

Mr Smith became a one-third shareholder of SIFA on 1 October 2006. He paid £15,000 for his shares and this price was said to be determined simply by reference to the net book value of the fixtures and fittings owned by the business. No value for goodwill was attributed to Mr Corbett's client relationships.

In 2012, their tax adviser recommended that conversion from a company to an LLP would suit the business. Interestingly, the judges said:

'The reason underlying this advice was not clear to us. It was claimed that the underlying rationale was that the corporate structure did not permit fair remuneration for the shareholder directors through dividends.'

Why was this the case? The speaker is certainly in agreement with the judges' point.

However, the change went ahead and SWM was formed. Pursuant to a business transfer agreement dated 1 July 2012, SIFA's business was transferred to SWM. Mr Corbett's capital account in SWM was credited with £1,179,000 and Mr Smith's capital account was credited with £1,017,000. Both credits were recorded as 'goodwill introduced'.

The business transfer agreement provided for the transfer and assignment of the business of SIFA as a going concern, together with all assets used in the business including 'the goodwill and the trade name "Simpsons Independent Financial Advisers" and lists of customers, suppliers, agents and others and all subsisting records, lists and information'.

The equity members of SWM were Mr and Mrs Corbett, Mr and Mrs Smith and SIFA.

The arguments

On 24 December 2014, HMRC opened an enquiry into SWM's partnership return for 2012/13, contending that they had discovered income received by the two appellants which ought to have been assessed to income tax and, on 19 April 2017, the assessments were duly raised. In other words, HMRC were arguing that the taxpayers' goodwill must have originally belonged to SIFA so that the relevant seven-figure sums represented distributions from SIFA to Mr Corbett and Mr Smith respectively.

This was disputed by the appellants who stated that the goodwill had never belonged to SIFA and so the company could not have made those distributions.

As one commentator put it:

'The goodwill belonged to each of them as individuals because they had their own reputation and strong client relationships.'

The First Tier Tribunal noted that there were no statutory provisions determining what constituted goodwill or how its ownership should be determined. Here, the nature of the asset was not in dispute but rather to whom it belonged before it was contributed to the LLP.'

The decision

The judges agreed with this latter viewpoint. The goodwill never belonged to SIFA and so was not an asset capable of being transferred from SIFA to another party. Consequently, the question of there being a distribution did not arise. The taxpayers' appeal was allowed.

Let the last word go to the Editor-in-Chief of 'Taxation':

'In many ways, this is a surprising outcome: one would generally expect that, if a company is providing advice to customers, the goodwill that is built up belongs to the company and not the individuals providing it. But the evidence of how goodwill is treated in the financial services industry was enough for the First Tier Tribunal to decide that a different analysis applied here.'

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