

Incorporation: Goodwill overvaluations

(Lecture B1214 – 12.48 minutes)

Background

When a sole trader or partnership incorporates so that the business operates through a company, there are several different ways the incorporation could be undertaken.

For example, the proprietor(s) might:

- Sell the business for shares in the company; or
- Gift the business assets to the company; or
- Sell the business for cash (with the proceeds often being left outstanding on a director's loan account, for the proprietor(s) to withdraw from the company as they wish if funds allow).

Market value

A disposal of chargeable assets on incorporation is normally a transfer between connected persons. For this purpose, a company is connected to another person if that person has control of it or if that person and persons connected with him together have control of it (TCGA 1992, s 286(6)).

Where the transactions are between connected persons, the rules of TCGA 1992, s 18 prevail; in particular, the transaction is to be treated as a bargain not made at arm's length. This, in turn, brings TCGA 1992, s 17 into play to the extent that the consideration for the business proprietor(s) disposal of the assets is to be treated as their market value for CGT purposes.

Goodwill valuation

The chargeable assets of the business could include goodwill. It needs to be goodwill that is capable of being transferred to the company, as opposed to personal goodwill, which is considered incapable of being transferred.

The valuation of assets such as goodwill is a highly specialised area. Even if goodwill has been valued by a professional valuer, it does not necessarily follow that HMRC's Shares and Assets Valuation division will agree with the professional valuer's valuation. In fact, there could be potentially major differences in valuations of the same asset by HMRC and the valuations expert.

Tax treatment of overvaluations

What if the goodwill is overvalued by the client or his professional adviser?

In April 2005, HMRC published a Tax Bulletin (Issue 76), which indicated that the excess consideration in such a scenario could fall to be treated in alternative ways; either as employment income, or as a distribution similar to a dividend.

HMRC stated that if goodwill was ‘... deliberately overvalued when it was sold to the company’ the excess payment by the company would be taxable as employment income and taxed accordingly. The excess payment would be liable to Class 1 National Insurance contributions.

Alternatively, the goodwill will often be transferred before the company has commenced trading. HMRC stated that, in the majority of cases where goodwill is transferred, any excess value would be received in the capacity of a shareholder, rather than an employee or director. A payment of excess value would therefore be treated by HMRC like a dividend (by reason of the distribution provisions in CTA 2010, ss 1000 and 1020).

HMRC’s analysis of the tax treatment of payments for goodwill in Tax Bulletin 76 is based on the premise that the goodwill has been deliberately overvalued. HMRC appear to accept in Tax Bulletin 76 that goodwill valuations are not an exact science and consider that distributions (within CTA 2010, s 1020) can be ‘inadvertent’. HMRC may therefore allow the transaction to be ‘unwound’ in those circumstances.

However, there are conditions for this unwinding treatment to apply; firstly, ‘reasonable efforts’ must have been made to carry out the transaction at market value using a professional valuation (or, as HMRC puts it, an ‘independent and suitably qualified valuer on an appropriate basis’); secondly, there can be no unwinding of intentional overvaluations; and thirdly, there must be no tax avoidance motive. If a distribution is unwound, the shareholder must repay the excess value to the company.

Partial DLA repayment

What if the distribution is not unwound, but the company is terminated before all the sale proceeds for the goodwill can be paid to the shareholder? Is the distribution element the original proceeds less the agreed goodwill valuation, or the amount withdrawn by the director shareholder in excess of the agreed goodwill valuation?

In *Pickles v Revenue and Customs* [2020] UKFTT 195 (TC), a husband and wife in business as a partnership business sold all its assets to a related company (HFPL) in May 2011. HFPL was established for the purpose of incorporating the partnership, and the incorporation was driven by commercial considerations.

The value attributed to goodwill sold on the incorporation, which was credited to the directors’ loan account, was £1,199,043. This figure was based on a calculation by the appellants’ former agents.

HMRC assessed the difference between the originally attributed goodwill figure of £1,199,043 and the agreed value for goodwill of £450,000 to income tax as a distribution; so the distribution by HMRC’s reckoning was £749,043. The taxpayers appealed. In July 2014, HFPL was placed into administration, before being dissolved in October 2015. None of the balance owing on the directors’ loan account at the date of the administration (i.e. £427,180) was repaid.

HMRC and the taxpayers initially agreed that the goodwill transferred should be valued at £450,000. However, at the First-tier Tribunal, HMRC’s expert witness recommended a goodwill valuation of £270,200. The tribunal accepted this figure and determined the market value of the goodwill to be £270,200.

The tribunal also noted that following the business sale, the appellants received cash of £771,863 from HFPL for the sale of the goodwill. This exceeded the market value of £270,200 by £501,663.

The tribunal decided that a 'distribution' had been made to the taxpayers. The amount of the distribution in the tribunal's view was the benefit received in excess of the value of the consideration given for the asset transfer (i.e. £501,663). The tribunal disagreed with HMRC's argument that simply by crediting a director's loan account with £1,199,043 the company made a distribution for tax purposes (CTA 2010, ss 1000 and 1020).

The tribunal therefore decided to the extent that the cash of £771,863 received from the company in partial repayment of the directors' loan exceeded the value of the goodwill amounting to £270,200, the difference of £501,663 was a benefit received by the taxpayers and a distribution for income tax purposes. However, the balance of the £427,180 debt that remained outstanding could not also be regarded as a distribution. The taxpayers' appeal was therefore partly allowed (by the tribunal Judge's casting vote, the other tribunal member dissenting).

More to follow?

The tribunal in Pickles noted that there appeared to be no authorities on the meaning of 'distribution' that might be of assistance in this context, and it was not possible to agree on the interpretation of the relevant law. There was an important point of widespread significance; the tribunal therefore gave HMRC permission to appeal to the Upper Tribunal to provide definitive guidance and encouraged HMRC to do so.

Whether or not HMRC appeal to the Upper Tribunal remains to be seen, but in view of the First-tier Tribunal judge's comments, an appeal by HMRC seems highly likely.

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