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THE VALUATION OF UNQUOTED SHARES AND GOODWILL

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This Memorandum highlights the main rules that apply in valuing private company shares and goodwill in CGT and IHT situations and identifies the methods of valuation most commonly encountered in negotiations with HMRC.

Unquoted shares-introduction For the private company shareholder wishing to transfer shares as part of his tax planning a review of the company's Articles of Association will often be the place to start. As well as defining the income, capital and voting rights of the shares the Articles are likely to impose at least some restrictions on share transfers. They may also contain pre-emption provisions which could limit the shareholder's freedom to make the desired transfer. If a separate shareholders' agreement has also been drawn up, a transfer may only be permitted in specified circumstances.

Where the transfer restrictions are particularly stringent, selling a minority shareholding could be all but impossible in practice. However it would be premature to assume the shares necessarily have a nominal value for tax purposes. Although tax valuations are intended to reflect open market value, quirks in the rules can produce surprising outcomes and unwelcome tax consequences for the unwary.

Open market value

CGT and IHT share a common open market valuation standard. The relevant provisions are contained in s.272 TCGA 1992 and s.160 IHTA 1984. Subject to minor differences in wording, both s.272 and s.160 define value as the price the asset in question might reasonably be expected to fetch on a sale in the open market. Over the years the Courts have provided guidance on the characteristics of this notional sale and the following principles are generally accepted as applying:
• The sale is an imaginary event and any provisions in the company's Articles of Association which would prevent the shares from being sold are temporarily set aside
• The parties to the imaginary sale are hypothetical and not necessarily those actually involved in the company or business
• Subject to the special rules that apply in certain CGT and IHT situations (see below) individual shareholdings must be valued independently of any other in the company, and not in combination
The vendor is willing and not under any compulsion to sell, but will sell the asset at the best price available in the market at the time
• The purchaser is prudent and has access to all information that a prudent prospective purchaser might reasonably require if he were proposing to purchase the asset from a willing vendor by private treaty and at arm's length (s.273 TCGA 1992 and s.168 IHTA 1984)

Information relevant to the valuation

HMRC's interpretation of s.273 TCGA and s.168 IHTA, which has been broadly supported by the Courts, relates the information that can be taken into account in the valuation to the following:

a) The size of the holding in terms of the percentage of the company's voting capital it represents.

b) The financial outlay required to purchase the holding.

The general convention is that the purchaser of a majority interest will be entitled to receive all relevant information irrespective of commercial sensitivity, including details of any plans to sell or float the company. At the other extreme, the purchaser of a small minority holding is assumed to rely on published information only unless the amount of money involved is substantial.

There are no hard and fast rules to rely on in deciding precisely what information is relevant to a particular valuation, although use of hindsight information is generally not appropriate. In the final analysis the relevance of information with a potentially significant impact on value may have to be debated with HMRC.

Valuations for CGT purposes

The most common situations when valuations are necessary are as follows:

• To substitute market value on disposal when the transaction is between connected persons (usually family members but see s.286 TCGA 1992 for a full definition) or is otherwise not a bargain at arm's length

• To establish base cost at 31 March 1982 The shareholding to be valued depends on which of these situations is relevant and whether any special rules apply.

Market value on disposal

In general, CGT valuations are based on the number of shares disposed of rather than the shares held before the disposal. In other words, if A holds 100% of a private company and disposes of 20%, the CGT valuation is likely to involve a 20% holding and not a 20% interest in a 100% holding.

However, in CGT situations the provisions of s.19 TCGA 1992 link all disposals made by a taxpayer to connected persons/parties within a six year period. S.19 is an anti-avoidance measure designed to prevent a tax advantage being gained by the piecemeal disposal of a shareholding (or another asset) in a series of transactions. This can lead to adverse and unexpected tax consequences. For example, if A disposed of three 20% minority shareholdings to connected persons in a six year period the subject of valuation would be a combined 60% holding and not three separate 20% minority interests which in aggregate would probably be less valuable.

1982 base cost

By HMRC concession, the general rule is to value all shares of the same class held by the taxpayer on 31 March 1982. This applies even where the base cost is used to calculate the gain arising following the disposal of only part of the holding. For example A owns 100% of Company C on 31 March 1982 and the base cost of A's shares needs to be established as a result of a disposal of 10% of the holding in 2005. The 1982 base cost of the shares disposed of will reflect the value per share of a 100% majority holding rather than the lower value of a 10% minority interest resulting in a smaller chargeable gain. This is different from the rule that applies in 'market value on disposal situations' – as explained above.

It should be noted that any shares owned by the taxpayer's spouse or civil partner will usually be valued separately and not combined with the taxpayer's holding. There are two exceptions to this general rule under Statement of Practice 5/89 (SP5/89) and Extra Statutory Concession D44 (ESC D44), as follows:

i) SP 5/89 treats any shares acquired after 31 March 1982 as part of the taxpayer's holding for base cost purposes if the shares were acquired on a no gain/no loss basis from someone who held them at that date.

ii) (ii) ESC D44 allows the value per share of a larger holding from which the deemed 1982 holding in (i) is derived to be used for base cost.

For example if A owned 100% of Company D on 31 March 1982 and subsequently gifted 25% to B after which the company was sold, B is deemed to have held a 25% interest for March 1982 base cost purposes due to SP5/89. Under ESC D44, subject to a claim being made, B's holding would be valued as part of a 100% controlling interest rather than at the lower value of a 25% minority holding.

IHT valuations

The rules that apply to IHT valuations are different from those in CGT situations. The main provisions are as follows:

- The charge to tax is based on the reduction in the value of the transferor's estate as a result of a transfer and not on the value of the transferred property itself. Unless all of the property is transferred, two valuations will be necessary, reflecting the position before and after the transfer. For example, H owns a 55% controlling interest in Company E and transfers 10% to a discretionary settlement. It is necessary to value holdings of 55% and 45% (i.e. 55% less 10%) rather than a holding of 10% in order to ascertain the amount chargeable to tax. This point is often crucial in tax planning, particularly where voting control of the company is lost as in the example.

- 'Related property', i.e. property owned by the transferor's spouse or civil partner, is also taken into account in determining the valuation holding. For example, if H owns 40% and W 15% of Company F and H makes a chargeable transfer of 10% the required valuations are as follows: Remember, these details are for information only.

  Before the transfer H's 40% minority holding as part of a combined 55% controlling interest.

  After the transfer H's remaining 30% holding as part of a combined 45% minority interest.

- Shares of different classes in the same company, shares in different companies and sometimes shares and other property are also combined in valuing the transferor's estate. For example, the freehold of a farm used by a farming company is likely to be more valuable if the transferor personally owns a controlling interest in the company.

Shares and Assets Valuation

A specialist unit of HMRC, Shares and Assets Valuation ('SAV'), has responsibility for considering valuations involving private company shares, goodwill and other intangible assets for tax purposes. Usually SAV will be instructed by another part of HMRC, for example the relevant tax district or specialist office, and in most circumstances will not comment on a valuation proposed by a taxpayer until instructions have been received.

If the value offered by the taxpayer is unacceptable the taxpayer/representative will be asked to justify the value used and negotiations may follow. SAV will generally try to agree a revised value close to its own valuation as soon as possible. Reaching agreement with can take some time where the case is complex and/or substantial amounts of tax are at stake. If negotiations do not result in an acceptable value, HMRC may seek to have the value determined on appeal by the Special Commissioners. This option is also open to the taxpayer but professional advice should be sought before a decision is taken.

Commonly encountered valuation techniques

There are no hard and fast rules as to which method or methods of valuation should apply in any given circumstances. However, in practice SAV tends to follow these approaches:

Investment companies and farming companies are generally valued on a net assets basis. This approach may also be used where a trading company is making losses and is not expected to return to profit in the short term. The company's net asset value may be revised to take account of the actual value of property assets and a discount then be applied depending on the size of the shareholding as a proportion of the company's voting share capital.

Majority and substantial minority interests in profitable trading companies are generally valued at the appropriate proportion of the value of the company as a whole, less a discount where appropriate. Company value will usually be based on a capitalisation of maintainable pre tax profits unless practice in the particular industry or sector it operates in follows a different approach. Any evidence of value in the form of offers or expressions of interest from potential purchasers will also be considered and may be taken into account. A discount may be appropriate depending on the size of the shareholding and the facts of the particular case. In general the discounts that apply in trading company situations are greater than for investment companies.

Smaller minority holdings in trading companies may be valued on the basis of dividends, maintainable post tax profits or a combination of the two. SAV's preference is usually to avoid a valuation of the company as a whole in these situations and so notional adjustments to, say, add back excessive directors' remuneration will generally not be relevant. A comparison with investment returns in quoted companies operating in the same industry sector will usually be made with an adjustment to reflect the disadvantages of investing in a private company e.g. transfer restrictions, the lack of a market for the company's shares ('unmarketability'), the private company's smaller size etc.

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Goodwill – introduction

Although the withdrawal of the 0% corporation tax rate on profits under £10,000 has probably led to a fall in the number of sole traders and partners deciding to incorporate their businesses, the value of goodwill transferred to a newco on incorporation will generally have to be agreed with HMRC.

What is goodwill?

A leading judge once said that goodwill is easy to describe but very difficult to define. He offered the view that goodwill was the benefit and advantage of the good name, reputation and connections of a business and the attractive force which brings in new custom. He also observed that it is the one thing that distinguishes an old established business from a new venture. Understanding the nature of the goodwill, if any, that attaches to a business or company is vital in any situation where the value of goodwill has to be agreed with HMRC for tax purposes.

HMRC's view is that there are four types of goodwill:
- Personal goodwill
- Inherent goodwill
- Adherent free goodwill
- Separable free goodwill

Personal goodwill reflects the reputation, skill and attributes of the business proprietor or other key individuals and is personal to them. It will generally be found in service industries in situations where the presence of certain qualities is essential to the success of a business. Typical examples include creative businesses such as hairstyling and advertising or the reputation of a well known chef in the context of a restaurant's trade. As personal goodwill is incapable of sale, it cannot be disposed of in a CGT context either along with the business or independently of it. Inherent goodwill (also known as 'site goodwill') relates to the location of a business rather than how it is carried on or the personal attributes of the proprietor.

Inherent goodwill is commonly encountered in trades where customers have a choice of supplier and the success of the undertaking is due to factors such as the convenience or attractiveness of location (e.g. a public house or restaurant) or proximity to a similar business (e.g. a high street shop). As it is an indivisible part of the value of the freehold premises it cannot be sold separately.   Where the value of inherent goodwill has to be established for tax purposes the responsibility lies with the Valuation Office Agency of HMRC, which will consider the trading accounts of the business in assessing value.

Adherent free goodwill is similar to inherent goodwill in that it can only be disposed of along with the premises and business. It arises where a business in carried on from premises which have been specifically adapted or licensed for that purpose, for example a public house or a nursing home.

Separable free goodwill is entirely separate from the proprietor and the premises. HMRC considers separable goodwill to be the only goodwill that can be transferred independently of the business premises. Where goodwill is transferred to a newco on incorporation HMRC considers that only the value of separable free goodwill, if any, will be relevant.

HMRC's division of goodwill into these categories was rejected by the Special Commissioner in the recent Balloon Promotions case (Balloon Promotions Ltd and others v Wilson and Rodin SpC524 3 March 2006), which concerned the availability of roll-over relief following the sale of a franchised business. HMRC had refused relief on the grounds that any goodwill belonged to the brand rather than the business and the element of the sale proceeds attributed to goodwill was in fact a payment for termination of the franchise agreements. Although the taxpayers' case was upheld by the Special Commissioner, HMRC maintains its position on types of goodwill is correct, arguing that the decision was reached on the facts of the case and is not of general application.

Value of separable free goodwill

As a general proposition, free goodwill is represented by the worth of a business over and above its net asset value. SAV usually quantifies the value of goodwill using one or more of the following methods:

Custom of the trade. Where the goodwill of businesses operating in the relevant industry or sector is typically acquired by reference to a particular measure (for example turnover, gallonage, fees/commission or gross profit) SAV will follow the same approach. Examples of industries where this applies include book-makers, estate agents, insurance brokers, newsagents, employment agencies and exhibition organisers amongst others.

Capitalisation. If 'custom of the trade' does not apply the company or business is likely to be valued on a capitalisation of profit, with free goodwill calculated by deducting the book value of the assets supporting the trading activities from the capitalisation value. Where the business is a partnership or sole trader, a notional allowance for the market value of the proprietor's services will be included in determining profits.

Super profits. This approach may be used to value goodwill in smaller businesses where the profits of the business in question represent an above average return ('super profit') on the assets employed. For example, if the assets of a business could be expected to earn a return equivalent to £50,000 per annum but actual profits are £75,000, the super profit element (£25,000) would be capitalised (perhaps at 2 – 3 years of purchase) to estimate goodwill value.

Practical points - goodwill

SAV provides a post transaction valuation check service in CGT situations so that the value of goodwill can be agreed before a self-assessment tax return is completed.

SAV will consider whether the goodwill is capable of being transferred and whether the value claimed is realistic. If the market value of goodwill is ultimately established to be less than the value claimed the excess may be treated as either a distribution or remuneration subject to income tax rather than CGT. It is therefore important that the nature of goodwill in the business is properly understood before steps are taken and can be justified to HMRC if necessary.

We will be happy to advise you on any of these issues.

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Please note that this Memorandum is not intended to give specific technical advice and it should not be construed as doing so. It is designed merely to alert clients to some of the issues. It is not intended to give exhaustive coverage of the topic. Professional advice should always be sought before action is either taken or refrained from as a result of information contained herein.