SELLING YOU BUSINESS - GOODWILL

Goodwill is the price paid for the business over and above the market value of the nett assets of the business.

It is very easy to describe but very difficult to define. Especially as there are differing definitions when looked at from the standpoints of accounting, property, law and tax.

In economics it is regarded as being the excess over the profit than could reasonably be expected that the assets generate, otherwise known as “super profits”.

There is greater importance on the identification of the goodwill for the purchaser rather than the seller of the business but the seller should be thoroughly aware of what is involved to avoid disagreement in the sale or dispute on the ultimate price.

Most businesses will include land or buildings in the sale price whether these are freehold or leasehold. This property (technically when viewed as stripped of its chattels) will have a market value less than its sales price and this is important for three main reasons.

Firstly it is relevant for Capital Gains Tax purposes as defined in the Tax of Chargeable Gains Act 1992. It is important to know what is revenue and what is the capital gain as different rates of taxation may apply for the seller.

Secondly the purchaser may be liable for Stamp Duty Land Tax on the purchase price of land and buildings. However, this is not payable on the element which is goodwill contained within the overall price of the property (note the property not the assets of the business). Thus the purchaser will wish to maximise the goodwill element of the price.

Thirdly the goodwill may have relevance when it comes to determining capital allowances. Capital allowances are more familiarly known as depreciation although the two are not the same as depreciation is only used for the internal workings of the business and not for tax purposes.

In the past it was common to hear the expressions relative to goodwill as it being “free”, “adherent” or “inherent”. Insofar as HMRC is concerned these differing terms are irrelevant and goodwill is now simply goodwill.

HMRC do not stipulate exactly what level of goodwill should apply to a business but operates instead on a case by case basis depending on the facts. A “just and reasonable” basis is the rule of thumb.

In all cases the apportionment - that is the breakdown of the business sale price into goodwill and other assets - should be agreed in advance of the sale by the purchaser and seller. HMRC and the Valuation Office Agency should be approached for advance approval of the apportionment.

Although the business balance sheet gives a value to the assets of the business that is not usually the valuation accepted by the HMRC or others such as banks. The correct valuation is the market value. There is no one formula for calculating that valuation; it must be “just and reasonable”.
The market value can be taken as not necessarily what the current business owner generates for the business but what a reasonably efficient operator could achieve by running the business.

Also a value should be determined as if it is an arm’s length sale on the open market. It may be the business is to be sold to a family member or friend and that consideration paid may be less than the definition given. That may have further tax implications.

Further there are different market values at arm’s length sale given to publicly owned businesses (where the shares are traded on an open market) and privately owned business. As a rule of thumb private companies can be valued at a price to earnings ratio of one half of those in the public sector.

Many of the issues will arise for what is known as trade related properties which form the mainstay of the business. Examples of this category are pubs, hotels, restaurants, hairdressers, beauty salons, cinemas, filling stations and care homes.

Another complication is the separation of goodwill and other intangible assets. Other intangibles can include licences, supplier lists, trademarks, patents, copyright, design rights and skills to name but a few.

Goodwill is a complex area and the above is only a general guide and introduction of which both the business purchaser and seller should be aware.

If you have any queries arising from this paper or would like to discuss any other matter, please do not hesitate to contact Calum I Duncan or his colleagues.

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