Analysis

Goodwill and its relations

SPEED READ The taxation of goodwill under the intangible fixed assets regime for corporates gives rise to a number of subtle – and increasingly financially meaningful – questions of law and accounting practice. These arise from the confluence of a number of factors: the sui generis nature of goodwill in accountancy; the draftsman's decision to shoehorn it into the regime for the taxation of intangibles; its propensity to be acquired as part only of a bundle of assets; a growing tendency towards the disaggregation of baskets of intangibles; and the growing weighting of intangibles in an entity's balance sheet. Upon the answers to these questions can depend very substantial amounts of tax.

Jolyon Maugham is a barrister at Devereux Chambers who specialises in revenue law with a predominantly litigation based practice. He is on the attorney general's 'A' panel of counsel. Email: maugham@devchambers.co.uk; tel: 020 7353 7534.

I recently had cause to enquire of a senior accounting expert the cause of the sharpening of professional focus on the precise accounting characterisation of different types of intangible asset. Was it a function of the statutory regime for the taxation of those assets, I asked? Was it that accountants faced commercial pressure to shift assets into more readily depreciable categories in order to reduce taxable trading profits? 'No,' he said. 'It is only tax lawyers who are obsessed with generating losses. Most business people see benefit in enhancing their profits.'

Even so. That my unifying hypothesis for the shift to a granular balance sheet treatment of intangibles was demonstrably wide of the mark – the better explanation, as I now know, being IFRS 38 – does not obscure the fact of that shift. In this article, I mean to examine some questions arising out of it. I mean to focus only on the accounting based corporation tax regime to be found in, now, CTA 2009 Part 8. Different considerations apply in other regimes for the taxation of goodwill, such as, for example, capital gains tax.

The taxation of intangibles regime

For fiscal purposes, the taxation of intangibles regime implements (in the modern fashion) the accounting treatment of intangible assets that is produced by generally accepted accounting practice (see CTA 2009 s 711(5)), but subject to certain adjustments.

That statutory implementation occurs through the mechanisms set out in Chapters 2, 3 and 6 of Part 8, through which accounting credits and debits are brought into account for tax purposes. Where your accounts are GAAP compliant, you translate your accounting debits into entries in the expenses section of your CT return and your credits to the receipts section. Where, however, your accounts are non-GAAP compliant (or indeed where you have not prepared accounts), there is an additional step (see s 717). You begin by calculating what your debits and credits would have been were your accounts GAAP compliant. Having taken that initial step, you then again shift those (this time, hypothetical) debits and credits to the appropriate sections of your CT return.

There are also, as I have said, instances where Part 8 requires adjustments to the GAAP treatment. Perhaps the most important of these is s 864, the TAAR, which provides that in determining whether any debits or credits are to be brought into account, one ignores 'tax avoidance' arrangements. Section 864 was, of course, the subject of the *Iliffe News and Media* case [2012] UKFTT 696 (TC) in which the tribunal concluded that certain accounting debits were, in effect, unallowable. However, there are a whole series of other statutorily prescribed diversions from the GAAP code. With the single exception of a provision concerned with the financial disaggregation of bundles of intangibles, considered below, these adjustments are outside the scope of this article.

Goodwill and bundles of assets

For accounting purposes, at least – lawyers see the matter differently – goodwill is not an asset at all. It is a mere placeholder or 'bridge' (to borrow from recital para f to FRS 10) in the accounts which ensures that the figures on the left and right side of the balance sheet do balance. It is this fact of accounting practice, of course, that creates the necessity for CTA 2009 s 715, which provides that Part 8 applies to goodwill 'as it is applies to an intangible fixed asset'.

However, this rather sui generis nature of goodwill, together with the 'reliable measurement' precondition in FRS 10 for the recognition of an asset separate from goodwill, for many years encouraged a tendency on the part of many entities to treat goodwill as a portmanteau category, rather than a discrete placeholder. By portmanteau, I mean, of course, a heading into which can be swept a number of – on proper analysis – discrete explanations for the difference between the price paid and the assets separately recognised on the balance sheet.

For accounting purposes at least, goodwill is not an asset at all. It is a mere placeholder in the accounts

With the benefit of the granular approach highlighted above has come a tendency to seek to unpack that portmanteau, working alongside one's tax advisers, and to uncover differing and sometimes fiscally helpful treatments of that which is disaggregated. And IFRS 38 enables one more readily to bring one's auditors on board with proposed accounting treatments.

With new acquisitions, one might look to the relationship between:

- the question of how one accounts for the difference between tangible assets and price paid; and
- the fiscal consequences of that characterisation in considering the appropriate balance sheet entries.

Indeed, one might take a step further back still and think about those fiscal consequences in considering how to 'lawyer' the commercial deal struck by the parties. More difficult is the situation where, looking back, you see on your balance sheet the portmanteau 'goodwill' and not the specific entries that might have instead been recorded. Is that portmanteau irremediably locked?

One needs to take that question in stages. The first is to ask whether the accounting treatment adopted on the acquisition of that bundle of assets – namely, bundling them all together as 'goodwill' – was in accordance with generally accepted accounting practice. On one school of accounting thought, once you conclude you have a separate intangible asset, you are obliged to show it (and separately) on your balance sheet. Another adopts a more nuanced approach and requires the directors to confront the substance of the separate assets acquired. The resolution of these differing approaches is, of course, no longer a task for a lawyer; the effect of the draftsman's adoption of an accounting based treatment of intangibles is to reduce that class of professional to the role of mere facilitator. But I note those schools for information's sake.

The valuation of goodwill is an exercise in simple subtraction … although the subtraction may be simple, the calculation of the value of the subtrahend may not be

You would then proceed from your assessment of whether you had correctly accounted for the original acquisition. If your then accounting treatment was not GAAP compliant, the statute would compel you to recalculate your credits and debits for the purposes of Part 8 on the hypothesis that you had adopted a GAAP compliant treatment. In that world, you would make adjustments to earlier years for tax purposes where those years were still open and you would adopt the new treatment going forward. (I should note that Chapter 15, which deals with 'Adjustments on change of accounting policy' and effects a one off adjustment, would not be engaged: see s 871(1)(b).) But what if you concluded your original treatment was GAAP compliant?

In that situation, regard must be had to s 856. That provision addresses the situation where groups of assets are acquired (or realised) together as a result of a single bargain ('bargain' being a concept explicitly wider than 'contract'). It provides that if:

- assets are acquired together; and
- values are allocated to those assets in accordance with GAAP,

then those values must be accepted for the purposes of Part 8. However, and this is still an open question, if you have not allocated a value to an asset it may well be that a just and reasonable apportionment of your acquisition expenditure as between the assets is mandated.

In other words, the provision goes further than merely confirming the GAAP compliant treatment of assets acquired in a bundle. In the situation in which a bundle of assets is acquired together and some or all are recognised in the balance sheet under the portmanteau heading of 'goodwill', section 856 arguably requires an allocation of the consideration between those assets, whether or not such an allocation is required under GAAP. Putting the same point another way, if all that section 856 did was to require a GAAP treatment, it would be an empty set in light of ss 711 and 717. This analysis comes into sharper focus still if one looks at s 856(5), which deals with the situation where assets are realised together and requires a 'just and reasonable' allocation, irrespective of whether the treatment of the disposal in the accounts is or is not GAAP compliant.

It may also be that s 713(3) provides a similar gateway to claiming Part 8 debits (or suffering Part 8 credits) in circumstances where accounts are GAAP compliant. That subsection provides that Part 8 applies to intangible fixed assets, whether or not they are capitalised in the company's accounts.

So, summing up, even in circumstances where you have – in a GAAP compliant fashion – omitted in your balance sheet to recognise certain intangible assets separately from goodwill, you may still be obliged to treat those assets separately for the purposes of Part 8.

Goodwill and restrictive covenants

Another related complexity arising out of the taxation of goodwill is its, to put the matter loosely, economic overlap with other assets. FRS 10 explicitly recognises this difficulty. Appendix III to FRS 10 tells the story of the Accounting Standards Board's attempts, halting but ultimately successful, to draw a line in the sand between goodwill and those similar assets. The appendix repays careful attention on the part of those attempting to apply Part 8 to, in particular, purchased intangibles.

One of those assets 'similar in nature' (to borrow the formulation chosen by the drafters of the Appendix) to goodwill is, of course, unregistered trademarks. These were the subject of the aforementioned *Iliffe News and Media* case, in which the tribunal held (in a decision widely regarded as unsafe) that they could not be disposed of in gross.

An interesting question, unanswered so far as I am aware in the report of that case, but arising if one assumes the tribunal's decision to be right, is whether the legal analysis of the purported assignments as effective or ineffective mattered. As a matter of principle, the question of whether the would-be acquirer, Iliffe News and Media Ltd, should recognise the marks on its balance sheet is a question not of law, but of accounting practice. And accounting practice focuses not on the question of ownership, but rather on the question of control. Control may be asserted through legal rights but it may also be asserted by custody. On analysis, it may well be that the answer to the question of whether the purchaser of unregistered trademarks should recognise them on his balance sheet for accounting purposes (even assuming their assignment to him was void) is one which rests upon a careful and forensic analysis of all the terms of the agreements purporting to convey those marks.

Another class of assets, perhaps even more closely related to goodwill, is that of restrictive covenants.

Transfers of goodwill are often protected – or effected – by the giving of restrictive covenants by the vendor to the purchaser. As Lord Parker observed in *Herbert Morris v Saxelby* [1916] 1 AC 688, 709:

'Without … a covenant on the part of the vendor against competition, a purchaser would not get what he is contracting to buy, nor could the vendor give what he is intending to sell.'

Generally, the benefit of restrictive covenants is (although there are exceptions) recognised as goodwill on an entity's balance sheet. However, there are compelling accounting arguments that they are, on analysis, separate assets. This analysis is always worth exploring.

Restrictive covenants are effective only for a prescribed (and usually relatively short) period of time. And as a matter of accounting practice, they must be amortised over that time frame. Compared with the accounting treatment of goodwill (which might be amortised over 20 years), separate capitalisation stands to offer much shorter amortisation time frames.

The analysis of a transaction as involving the acquisition of restrictive covenants can also offer advantages in circumstances where the transaction comprises the purchase by P of shares in T, rather than of T's assets. HMRC's practice is to adhere rigidly to the view that, on such a purchase, P cannot recognise goodwill from that acquisition on its balance sheet. Whether this conventional approach is right or wrong – and there are powerful arguments in both a legal and accounting context that it is wrong or is sometimes wrong – it cannot sensibly be argued that P does not acquire a separate intangible asset, being the benefit of the restrictive covenant. This alternative analysis may assist in relation to certain types of what the legislation describes as pre-FA 2002 assets.

These issues, and others, were argued in a recent First-tier Tribunal case, which settled before judgment was handed down.

Valuation issues

The final point I mean, briefly, to discuss is that of the valuation of goodwill.

'Briefly' because, as can quickly be seen, it is not a question capable of arising, at least in the context of the corporation tax regime. (Although I should note that valuations of goodwill are routinely required for capital gains tax purposes; see, for a recent example, *Wildin v HMRC* [2014] UKFTT 459 (TC)).

For corporation tax purposes, one starts with the price paid for the basket of assets (call it X), one subtracts the value of the other's assets (Y) and the remainder is goodwill (Z). The valuation of goodwill is thus an exercise in simple subtraction. Trite though it may seem, this explanation is one which recognises the essential quality, for accounting purposes, of goodwill as not an asset, but rather a placeholder in the balance sheet.

Of course, although the subtraction may be simple, the calculation of the value of the subtrahend (the number in a subtraction which is to be subtracted) – the Y in my example – may not be. But an ability to resolve this difficulty is inherent in the decision to recognise Y as a separate asset in the first place. Paragraph 10 of FRS10 says that you can only recognise an intangible asset acquired as part of the acquisition of a business if its value can be measured reliably on initial recognition. Unless you can value your Y, you don't have one. So the question of the valuation and recognition of Y (and through it, of Z) are inextricably intertwined. ■

For related reading, visit www.taxjournal.com

Cases: *Iliffe News & Media Ltd v HMRC* (29.11.12)

Cases: *GM Wildin v HMRC* (28.5.14)

Goodwill and trade-related premises (Lakshmi Narain, 1.9.11)

Comment: Should HMRC value goodwill? (Mark Bevington, 6.12.13)

Adviser Q&A: *Mertrux Ltd v HMRC*, goodwill and roll-over relief (Rachel Gauke, 19.7.13)

SDLT and goodwill (Patrick Cannon, 2.2.09)

***Williamson Tea*, NCAs and goodwill** (Jeanette Zaman, 25.10.10)

Ask an expert: Transfer of goodwill impairment (Marios Gregori, 11.7.12)