

Goodwill on Incorporation

Save tax with goodwill!

Following on from [Topical Tips 67](#) we have been asked about the treatment of goodwill on incorporation of a business.



Why is 'goodwill' an issue?

Goodwill is the difference between the price the purchaser pays for the business and the value of the underlying assets. For example a business might have assets worth £100,000 (e.g. plant and machinery, stock, debtors less creditors), but will be worth more than £100,000 as it is capable of generating profits over and above the management cost of running it.

Income earned by an individual is taxed at a basic rate of tax of 22% and at 40% for the higher rate. However, capital gains tax paid by an individual on a business asset owned for only two years is just 10%, so selling 'goodwill' can save tax.

The tax treatment

In April 2005 HMRC published their commentary on the tax treatment of goodwill purchased in two circumstances:

- when the seller of the business is selling to his or her own company
- when the seller of the business is selling to someone else's company and is joining as an employee

The Inland Revenue are on the look out for goodwill sold at an overvalue. If the goodwill was sold to a new company in which the taxpayer is a shareholder then the inflated goodwill value will probably be taxed as a distribution (like a dividend) and the taxpayer will be liable to additional tax if the distribution to them is at their higher rate of income tax.

If the goodwill was purchased at an inflated value as an inducement for the seller of the goodwill to take up employment with the company or in return for future services (e.g. a depressed pay packet) then the inflated value of the goodwill will be taxed as employment income. It is up to the employing company to declare the PAYE and NIC on the amount or, in exceptional circumstances, put the amount on the P11D as a benefit.

The taxman is watching

H M Revenue & Customs ('HMRC') is alert to individuals incorporating their own businesses and selling the business to their own limited company with inflated rates of goodwill. Taxpayers trying to swap income tax rates for the 10% capital gains tax on businesses assets need to take care.

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- HMRC offers a review service that allows a taxpayer to submit details of completed transactions for review to check the goodwill value. If HMRC does not agree with the goodwill value then the arrangements can be revised before submitting the tax return. In some cases a transaction can be completely 'unwound' if it was not the intention of the taxpayer to transfer excess value and reasonable efforts were taken to transact at market value.
- An additional attraction to the purchaser in buying goodwill is that since 31 March 2002 a purchaser of goodwill is able to obtain tax relief for the writing down of that goodwill in their accounts. If a sole trader incorporates his or her business by selling goodwill to their own company then the company will only be able to obtain such a relief against taxable profits if the goodwill was created by the sole trader after 31 March 2002.
- If both the date of the creation of the goodwill and the value of the sale to a new company can be justified then this would be a very attractive route for a new business to plan to take.
- Companies can now obtain tax relief for goodwill purchased. This is not available to individuals or partnerships.
- On selling goodwill in a connected person transaction, i.e. selling your personal business to your own company, then the company can claim tax relief only if the goodwill was created after 1 April 2002. If the business bought commenced before this date then relief will not be available.

Consult your Barnes Roffe LLP contact partner for detailed guidance in this important area.