Neutral Citation Number: [2022] EWCA Civ 909

Case No: CA-2021-000643

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE UPPER TRIBUNAL
(LANDS CHAMBER)
Andrew James Trott FRICS and Diane Martin MRICS FAAV
[2021] UKUT 0076 (LC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 01/07/2022

Before :

LORD JUSTICE LEWISON
LORD JUSTICE WARBY
and
LORD JUSTICE SNOWDEN

- -

Between :

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS	**Respondent/ Appellant**
- and –	
(1) ZYRIEDA DENNING **(2) MH HANTS LIMITED** **(3) MP HANTS LIMITED**	**Appellants/ Respondents**

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John Brinsmead-Stockham (instructed by the **Solicitor's Office and Legal Services**) for the **Appellant**
Michael Firth (instructed by **Morrisons Solicitors LLP**) for the **Respondents**

Hearing date : 16 June 2022

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Approved Judgment

Remote hand-down: This judgment was handed down remotely at 10.30am on 1 July 2022 by circulation to the parties or their representatives by e-mail and by release to the National Archives.

Lord Justice Lewison:

Introduction

1. The issue on this appeal relates to the valuation of two leasehold interests in care homes for the purposes of capital gains tax and stamp duty land tax, where the valuations were carried out in accordance with the guidance given by the Royal Institution of Chartered Surveyors in VPGA 4. VPGA 4 gives guidance about valuing trade related properties. Where that valuation method is applied, is the resulting figure the value of the leasehold interest, or the value of both the leasehold interest and "transferable goodwill"?

The appeal

2. An appeal from the UT to this court lies only on a point of law: Tribunals, Courts and Enforcement Act 2007 s. 13 (1).

3. With the permission of Asplin LJ HMRC appeal on the ground that the UT were wrong to have attributed the agreed capital values to a distinct asset of transferable goodwill as opposed to the value of the leasehold interests themselves.

The facts

4. Dr Denning acquired the freehold interest in Manor Place Nursing Home together with the business operating from it in April 2000 for £499,000. She acquired a leasehold interest and the business operating from Maple House Nursing Home in March 2001 and subsequently bought the freehold interest in the property in June 2006 for £1m. Dr Denning operated both care homes as a sole trader.

5. On 3 February 2010 Dr Denning incorporated three companies: Jasmine Care Holdings Limited ("JCHL"); MH Hants Limited ("MHL"); and MP Hants Limited ("MPL"). MHL and MPL were wholly owned subsidiaries of JCHL and Dr Denning was the sole shareholder in JCHL.

6. On 22 March 2011 Dr Denning, as vendor, entered into three agreements with each of MHL and MPL to transfer one care home to each company. In summary the agreements provided for:

   i) the sale and purchase of the businesses as going concerns in consideration for "the appropriate book amounts" and including "the goodwill of the Vendor in connection with the Business". The agreements also provided that Dr Denning would grant leases over the properties from which the businesses were operated for a term of 5 years at an annual rent (without review) of £225,000 for Manor Place and £175,000 for Maple House;

   ii) the grant of the leases on the terms set out in (i) above with no premium payable ("the leases"). Dr Denning retained the freehold interest in both Manor Place and Maple House;

iii) deeds of assignment of the goodwill of the businesses from Dr Denning to MPL and MHL for consideration of £1,125,000 and £675,000 respectively, i.e. a total of £1.8m.

7. HMRC challenged the figures for goodwill and asserted that part of what had been described as consideration for goodwill was, in reality, part of the open market value of the leases. The appeal therefore concerns the open market value of the leasehold interests granted by Dr Denning to MPL and MHL under the leases.

The legal test

8. The valuations of the leasehold interests are required for the purposes of the Taxation of Chargeable Gains Act 1992. Section 272(1) of that Act states:

> "In this Act "market value" in relation to any assets means the price which those assets might reasonably be expected to fetch on a sale in the open market."

9. There was no dispute about the nature of open market value. The question, then, is how much each of the leases would fetch if sold on the open market.

Methods of valuation

10. There are a number of different methods by which property can be valued. The most common is by the comparable method. In essence, the valuer looks for an analogue which is as close as possible to that which they have to value, and which has been the subject matter of a real transaction. They then work on the premise that if the subject matter of their valuation were to be the subject of a similar transaction, it would command the same value as the analogue. Since the analogue will never be identical to the subject matter of the valuation, the valuer will have to make adjustments to the value revealed by the analogue in order to reflect the differences between the analogue and the subject matter of his own valuation. In the case of a property valuation the analogues are usually called "comparables".

11. Second, there is the investment method. This is appropriate where property is tenanted, and the valuer is asked to value the reversion. The valuer will have to estimate the level of risk that a buyer would be prepared to take in order to acquire the income stream. It will be necessary to determine the yield which an investor would require and then convert that into a multiple of years' purchase.

12. Third, there is the residual method, which is sometimes used to value sites with development potential. This operates by calculating the value of the completed development and then deducting the costs of achieving the completed development (including financing costs and developer's profit). The residual method requires the input of a large amount of data, which is rarely absolute or precise, coupled with making a large number of assumptions. Small changes in any of the inputs can cumulatively lead to a large change in the land value. Some of these inputs can be assessed with reasonable objectivity, but others present great difficulty. For example, the profit margin, or return required, varies dependent upon whether the client is a developer, a contractor, an owner occupier, an investor or a lender, as well as with the passage of time and the risks associated with the development. For this reason the

residual method is generally regarded as unreliable and should only be adopted in the absence of some other more reliable method.

13. Fourth, there is the depreciated replacement cost (DRC) method. This involves assessing the cost of replacing the land and the building with a modern equivalent, including all associated costs and then making appropriate deductions for depreciation and obsolescence of the actual buildings. It is used only in cases of specialised property; and it, too is regarded as a method of last resort.

14. Fifth, there is the profits method, which is used in valuing trade related property; and is the relevant method used in this case.

15. The overarching purpose of all these methods of valuation is to arrive at the value of property.

Trade related property

16. VPGA 4 sets out the current guidance given by the RICS for the valuation of trade related property (in the quotations that follow emphasis is in the original). The hearing before the UT focussed on that guidance, and the UT considered at [96] that it was appropriate to do so. It is thus common ground on this appeal that the guidance in VPGA 4 applies to the valuation. We must therefore examine VPGA 4 in order to decide whether, as HMRC assert, the UT made an error of law.

17. The rubric at the start of the guidance states that it is advisory rather than mandatory. It also states that it does not cover every circumstance and that valuers must always have regard to individual facts and circumstances.

18. It continues by setting out its scope:

> "1.1 Certain trade related properties are valued using the profits method (also known as the income approach) of valuation. The guidance below sets out the principles of this method of valuation but does not concern itself with the detailed approach to a valuation, which may vary according to the property to be valued.
>
> 1.2 This VPGA relates only to the valuation of an individual property that is valued on the basis of trading potential.
>
> 1.3 Some properties are normally bought and sold on the basis of their trading potential. Examples include hotels, pubs and bars, restaurants, nightclubs, fuel stations, care homes, casinos, cinemas and theatres, and various other forms of leisure property. The essential characteristic of this type of property is that it has been designed or adapted for a specific use, and the resulting lack of flexibility usually means that the value of the property interest is intrinsically linked to the returns that an owner can generate from that use. The value therefore reflects the trading potential of the property. It can be contrasted with generic property that can be occupied by a range of different

> business types, such as standard office, industrial or retail property.”

19. The guidance then goes on to define certain terms that are used in the valuation process.

> “*Fair maintainable operating profit (FMOP)*
>
> 2.4 This is the level of profit, stated prior to depreciation and finance costs relating to the asset itself (and rent if leasehold), that the reasonably efficient operator (REO) would expect to derive from the fair maintainable turnover (FMT) based on an assessment of the market’s perception of the potential earnings of the property. It should reflect all costs and outgoings of the REO, as well as an appropriate annual allowance for periodic expenditure, such as decoration, refurbishment and renewal of the trade inventory.
>
> *Fair maintainable turnover (FMT)*
>
> 2.5 This is the level of trade that an REO would expect to achieve on the assumption that the property is properly equipped, repaired, maintained and decorated.
>
> *Market rent*
>
> 2.6 This is the estimated amount for which an interest in real property should be leased on the valuation date between a willing lessor and a willing lessee on appropriate lease terms in an arm’s length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion. Whenever market rent is provided the ‘appropriate lease terms’ that it reflects should also be stated.
>
> *Market value*
>
> 2.7 This is the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm’s length transaction after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.
>
> …
>
> *Personal goodwill (of the current operator)*
>
> 2.9 This is the value of profit generated over and above market expectations that would be extinguished upon sale of the trade related property, together with financial factors related specifically to the current operator of the business, such as taxation, depreciation policy, borrowing costs and the capital invested in the business.

Reasonably efficient operator (REO)

2.10 This is a concept where the valuer assumes that the market participants are competent operators, acting in an efficient manner, of a business conducted on the premises. It involves estimating the trading potential rather than adopting the actual level of trade under the existing ownership, and it excludes personal goodwill.

…

Trading potential

2.13 This is the future profit, in the context of a *valuation* of the property that an REO would expect to be able to realise from occupation of the property. This could be above or below the recent trading history of the property. It reflects a range of factors (such as the location, design and character, level of adaptation and trading history of the property within the market conditions prevailing) that are inherent to the property asset."

20. Having defined its terms, VPGA 4 goes on to describe the method:

"3.1 The profits method of valuation involves the following steps:

Step 1: An assessment is made of the FMT that could be generated at the property by an REO.

Step 2: Where appropriate, an assessment is made of the potential gross profit, resulting from the FMT.

Step 3: An assessment is made of the FMOP. The costs and allowances to be shown in the assessment should reflect those to be expected of the REO – which will be the most likely purchaser or operator of the property if offered in the market.

Step 4:

a To assess the *market value* of the property the FMOP is capitalised at an appropriate rate of return reflecting the risk and rewards of the property and its trading potential. Evidence of relevant comparable market transactions should be analysed and applied.

b In assessing *market value* the valuer may decide that an incoming new operator would expect to improve the trading potential by undertaking alterations or improvements. This will be implicit within the valuer's estimate of FMT at step 1. In such instances, an appropriate allowance should be made from the figure resulting from step 4 to reflect the costs of completing the alterations or improvements and the delay in achieving FMT. Similarly, if the property is in need of repair and/or decoration to enable the REO to achieve the FMT, then an appropriate allowance should be made from the figure resulting from step 4(a) to reflect the cost of such repairs and decorations.

c To assess the *market rent* for a new letting, the rent payable on a rent review or the reasonableness of the actual rent passing (particularly when preparing an investment valuation), an allowance should be made from the FMOP to reflect a return on the tenant's capital invested in the operational entity – for example, the cost of trade inventory, stock and working capital. The resultant sum is referred to as the divisible balance. This is apportioned between the landlord and tenant having regard to the respective risks and rewards, with the landlord's proportion representing the annual rent."

21. Section 6 of VGPA 4 deals with the assessment of trading potential. It says:

"6.1 There is a distinction between the *market value* of a *trade related property* and the investment value – or its *worth* – to the particular operator. The operator will derive worth from the current and potential net profits from the operational entity operating in the chosen format. While the present operator may be one potential bidder in the market, the valuer will need to understand the requirements and achievable profits of other potential bidders, along with the dynamics of the open market, to come to an opinion of value for that particular property.

6.2 A *trade related property* is considered to be an individual trading entity and is typically valued on the *assumption* that there will be a continuation of trading.

6.3 When assessing future trading potential, the valuer should exclude any turnover and costs that are attributable solely to the personal circumstances, or skill, expertise, reputation and/or brand name of the existing operator. However, the valuer should reflect additional trading potential that might be realised by an REO taking over the property at the *valuation date*.

…

6.5 For many trading entities, the vehicle for a transfer of the business will be the sale of a freehold or leasehold interest in the property. Such transactional evidence can be used as comparable evidence in the *valuation* of *trade related properties*, so long as the valuer is in a position to exclude the value of the component parts of the transaction that are not relevant. Examples include stock, consumables, cash, liabilities and *intangible assets* (such as brand names or contracts, to the extent they would not be available to the REO)."

22. Section 7 of VPGA 4 explains that the same method of valuation applies to a non-trading property, although different assumptions may have to be made.

23. Section 8 explains that the valuer may be asked to give an indicative apportionment of valuation for various purposes. Paragraph 8.2 says:

> "8.2 Any such apportionment of *market value* would usually relate to:
>
> • the land and buildings reflecting the trading potential and
>
> • the trade inventory."

The experts

24. Both Dr Denning and HMRC called expert evidence: Mr Ellis FRICS for Dr Denning and Ms Rodrigues MRICS for HMRC. Both experts produced written reports and were cross-examined. In addition, the two experts agreed a statement of common ground summarised by the UT at [10], as follows:

i) the valuation date is 22 March 2011, the date on which the relevant transactions occurred;

ii) the care homes to be valued are trade related properties ("TRP") for the purposes of the applicable RICS guidance and the leasehold interests are to be valued on the profits method of valuation;

iii) the profits method of valuation requires the assessment of the fair maintainable trade ("FMT") and fair maintainable operating profit ("FMOP") assuming the care homes were operated by a reasonably efficient operator ("REO");

iv) the FMT of Manor Place was £1.84m and the FMOP was £630,000;

v) the FMT of Maple House was £1.51m and the FMOP was £485,000;

vi) the FMOP figures should be adjusted by deducting the market rental value. The experts agreed that the passing rent under each of the leases was at the lower end of the range that could have been expected at the valuation date; but was nevertheless within valuation tolerances. It was reasonable to adopt those rents for valuation purposes. The adjusted FMOPs were therefore:

a) Manor Place: £405,000 (£630,000 less rent of £225,000 pa);

b) Maple House: £310,000 (£485,000 less rent of £175,000 pa).

vii) the profits method of valuation requires the rent adjusted FMOP to be capitalised using a year's purchase multiplier. The experts (in effect) agreed a compromise year's purchase of 2.125 which gave what they described as a mid-point capital value for the leasehold interest in Manor Place of £860,000 and of £660,000 for the leasehold interest in Manor House, giving a combined value of £1.52m.

viii) The value of the trade inventory was then deducted from these capital values. The experts agreed the following values for trade inventory:

a) Manor Place: £130,000;

b) Maple House: £117,500.

ix) The capital values for the leasehold interests less the trade inventory were:

a) Manor Place: £730,000 (£860,000 less £130,000);

b) Maple House: £542,500 (£660,000 less £117,500).

x) The freehold interests were to be valued on the investment basis and were agreed at: (a) Manor Place: £2.725m; (b) Maple House: £2.06m.

25. Both experts followed the guidance given by the RICS. Mr Ellis used previous guidance explained in GN1 and Ms Rodrigues used the current guidance explained in VGPA 4; although Mr Ellis said that his valuation would have been the same if he had followed VGPA 4.

26. It is to be particularly noted that the figures agreed by the experts as FMT and FMOP were higher than the figures achieved by the actual businesses themselves.

27. The case for HMRC was that the agreed capital values for the leasehold interests were their open market values reflecting trading potential. The case for Dr Denning was that included in the agreed values was both the value of the leasehold interest itself and also "transferable goodwill" or "business goodwill". The value of the leasehold interest was simply the market rent. The agreed capital value of the leasehold interest related solely to the value of the business goodwill. The transferable or business goodwill was an asset separate from the leasehold interest. She argued that the experts agreed that the rents passing under the leases were market rents, and it was obvious that a leasehold interest in property let at a market rent does not have a capital value.

The decision of the Upper Tribunal

28. As the UT (A J Trott FRICS and Diane Martin MRICS FAAV) said at [91]:

> "The parties have effectively asked the Tribunal to explain to them what they have agreed. But that is something only they can answer. The experts have agreed the market rent and ostensibly have also agreed the market value of the leasehold interests. Insofar as there is still a dispute in this appeal it therefore reduces to the question: what do the agreed valuations of the experts represent and which of them has adopted the correct approach?"

29. At [95] the UT held that it was wrong to value the properties as if they had been empty. As they put it:

> "We are concerned to value the properties in the condition and circumstances they were in at the valuation date and not what

> they might have been worth had they been empty. They were not empty, they were trading and we have valued them as such."

30. There is no appeal against that conclusion. At [96] they held that the valuation ought to reflect VPGA 4, which was the guidance in force at the time of the hearing, rather than GN 1, the previous guidance which it had replaced.

31. The UT set out its understanding of the issue at [99]:

> "What constitutes the land asset to be valued is a matter of law but how much that asset is worth is a matter of fact. [Dr Denning] seeks to show that the law recognises goodwill as a separate asset, distinct from the land asset. If that is so, then a valuation made on the basis that the goodwill is part of the land asset would be wrong in law."

32. At [106] the UT observed:

> "As its name suggests the profits method is concerned with the trading potential of the property being valued and in this case we need to consider whether the premium resulting from its application, excluding any personal goodwill, is solely indicative of the trading potential inherent in the leasehold interest or whether it also reflects other trading potential originating from the business conducted on the property."

33. There is an obscurity about the concluding words of this paragraph, which might be taken to suggest that the UT was looking at the actual business conducted at the property, rather than the market's perception of the profit-earning capacity of the property. But in its decision refusing permission to appeal, the UT clarified that it was not considering the actual business but that of a hypothetical REO. Mr Brinsmead-Stockham, for HMRC, accepted that clarification.

34. The UT then focussed on step 4 c of VGPA 4, which is concerned with the establishment of a market rent on a new letting. They said that the market rent was determined by taking a percentage of the FMOP and as such it reflected the trading potential of the property. They would have expected the tenant's proportion of the FMOP to represent the amount it would require from the business to induce it to take a lease at the market rent and make sufficient return on its risk and for profit (interest on capital having already been allowed for). But, they said, the tenant had paid a premium; and they posed the question: What was that for?

35. Their answer was:

> "[110] In our judgment the agreed market rent must *fully* reflect the trading potential available to the tenant under the terms of the 5-year lease which it was granted. If that were not the case, as the appellants argue, it would not be the market rent but something less. The premium reflects the fact that the tenant is leasing a fully equipped operational entity and, from a

> business viewpoint, is accepting a lower risk than having to start from scratch. That is a business advantage for which the tenant will be prepared to pay over and above the market rent.
>
> [111] The premium as calculated by the experts comes out of the tenant's proportion of the divisible balance but it does not form part of the value of the leasehold interest that is being granted. That value is fully represented by the market rent. In this case the profits method of valuation is being used to ascertain market rent, not market value."

36. At [117] they concluded that the trading potential of Manor Place and Maple House that was reflected in the agreed valuations could not reasonably be attributed solely to the leasehold interests; and that Dr Denning was correct to say that those valuations must also include transferable goodwill. They therefore decided that the value of the leasehold interests in Manor Place and Maple House was nil.

Profits valuation

37. In *Mohammed v Newcastle City Council* [2016] UKUT 415 (LC) Mr Trott himself considered the nature of a profits valuation. The claim in that case was a claim for compensation on the compulsory acquisition of a fish and chip shop. At [75] Mr Trott said:

> "The recognised method of valuing a trade related property is by using the profits method of valuation. This requires the assessment of the fair maintainable turnover that can be generated by a reasonably efficient operator from which is derived a fair maintainable operating profit which is then capitalised at an appropriate rate of return. In using this method a valuer will take into account, *inter alia*, the location and physical characteristics of the building, the trading accounts of the present operator, an analysis of the trading results of similar businesses and an assessment of future trading potential, profitability and market demand."

38. He then recorded a submission that the value of a freehold reflects the opportunity of establishing a going concern (the "possibility" of the land being used as a fish and chip shop) rather than the established going concern as it exists in the hands of the vendor (a "realised possibility"). Mr Trott rejected that submission. At [77] he said:

> "I think a better distinction is between open market value (reflecting the trading potential of the reference land to a reasonably efficient operator) and the value to the owner (reflecting the actual trading potential as established in the hands of the claimants). The valuation for open market value should be of the property as a place to do business and not a valuation of the business itself."

39. Thus Mr Trott accepted that the open market value does reflect the trading potential to a reasonably efficient operator. He went on to say at [79] that the profits method of

valuation combines the value of the business with the value of the property from which it is conducted. But that, as it seems to me, was an observation about the actual business carried on. Mr Trott went on to say:

> "The value to the owner cannot be less than the open market value, but it can be more if the capitalised profits that are actually achieved exceed those which are considered in the market to be fairly maintainable. But the profits method of valuation does not produce a separate freehold value distinct from the value of the business use which is conducted from the property. The two are inextricably linked and together give the value of the land to the owner."

40. In my judgment Mr Trott in this passage distinguishes between the open market value based on the trading potential to a reasonably efficient operator on the one hand, and the value to the owner if his actual profits exceed those which would be achieved by a reasonably efficient operator. This is the same distinction as that drawn by para 6.1 of VGPA 4 between market value and worth. I should also emphasise the point that Mr Trott made that the profits method does not produce distinct figures for the property value and the value of the business use which is conducted from the property: they are "inextricably linked".

41. I agree with Mr Brinsmead-Stockham that both the fair maintainable trade and the fair maintainable operating profit are hypothetical figures, which reflect the view that the market would take. As Hoffmann J put it in *Electricity Supply Nominees Ltd v London Clubs Ltd* [1988] 2 EGLR 152:

> "[The valuer] is concerned not with the actual earning capacity but with how the market would have assessed earning capacity."

Goodwill

42. The classic description of goodwill is found in the decision of the House of Lords in *IRC v Muller's Margarine Ltd* [1901] AC 217. The issue in that case was whether goodwill attaching to a German manufacturing business was situated outside the UK. The House of Lords held that it was. In a passage that has been frequently quoted, Lord MacNaghten said:

> "What is goodwill? It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation, and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old-established business from a new business at its first start. The goodwill of a business must emanate from a particular centre or source. However widely extended or diffused its influence may be, goodwill is worth nothing unless it has power of attraction sufficient to bring customers home to the source from which it emanates. Goodwill is composed of a variety of elements. It differs in its composition in different trades and in different businesses in

> the same trade. One element may preponderate here and another element there. To analyze goodwill and split it up into its component parts, to pare it down as the Commissioners desire to do until nothing is left but a dry residuum ingrained in the actual place where the business is carried on while everything else is in the air, seems to me to be as useful for practical purposes as it would be to resolve the human body into the various substances of which it is said to be composed. The goodwill of a business is one whole, and in a case like this it must be dealt with as such."

43. He went on to say:

> "For goodwill has no independent existence. It cannot subsist by itself. It must be attached to a business. Destroy the business, and the goodwill perishes with it, though elements remain which may perhaps be gathered up and be revived again."

44. Lord Brampton endorsed the view of Pollock CB in an earlier case that:

> "… there is a wide difference between the sale of a goodwill together with the premises in which the trade is then carried on, whereby the value of the premises is enhanced, and the sale of a goodwill without any interest in land or buildings connected with it, and which is merely the advantage of the recommendation of the vendor to his connections and customers, and his covenant to allow the vendee to use his trade name, and to abstain from competition with him.
>
> In the first of these cases the trade and the premises are inseparable so long as the trade is therein carried on. The advantages and facilities constituting the goodwill are all more or less derived from them, or the profitable results of such goodwill are therein realized. The goodwill of a trade carried on in a shop is as essential to the tradesman as the shop itself, which is benefited by it. What is the trade of a shop but the business done in it, and how is that custom brought to the shop but by the goodwill attached to it? The combination of a suitable shop with the trade done in it, and the goodwill inducing that trade, seem to me to be inseverable. In my judgment, it matters not whether the business be a manufacturing one, or that of a shopkeeper, or a publican, or a brewer; in each case the seller of his business premises with his goodwill sells, and the purchaser buys, the outgoing man's premises, with, so far as in him lies, the whole business carried on therein as a going concern, with the same prospects the vendor himself would have had, had he continued it; and I think it immaterial whether the business has been built up by reason of the personal good qualities of the outgoer, the goodness of his wares or merchandise, the good situation of the premises, or

> the absence of competition; in each case the business and custom, in fact, have been attracted to the house or premises, and when the incomer takes possession, he takes all the chances offered and conveyed to him by his purchase, of standing, so far as the business is concerned, in the shoes of the outgoer, and he must rely upon his own good qualities and aptitude for his undertaking to continue the prosperity of the business and profit by his bargain."

45. Lord Lindley said:

> "Goodwill regarded as property has no meaning except in connection with some trade, business, or calling. In that connection I understand the word to include whatever adds value to a business by reason of situation, name and reputation, connection, introduction to old customers, and agreed absence from competition, or any of these things, and there may be others which do not occur to me. In this wide sense, goodwill is inseparable from the business to which its adds value, and, in my opinion, exists where the business is carried on."

46. As these passages demonstrate, goodwill attaches to an actual business. I find it difficult to see how goodwill can be attached to a hypothetical business. In that sense goodwill (which attaches to an actual business) must be distinguished from trading potential which is part of the value of the property itself. That is reflected in the way in which Mr Trott described a profits valuation in *Mohammed*, distinguishing between open market value on the one hand and value to the owner on the other.

47. Where one is dealing with goodwill attaching to an actual business, it is now generally accepted that the subdivision of goodwill is unhelpful; although it may be necessary to do so for certain purposes: *Whiteman Smith Motor Co Ltd v Chaplin* [1934] 2 KB 35; Wadlow on Passing Off (6th ed) para 3-43. The UT said at [118]:

> "The subdivision of goodwill into different types is generally no longer considered helpful, e.g. inherent (or locational) goodwill, personal goodwill, free goodwill - which in turn can be further subdivided into adherent (or adaptational) goodwill and transferable goodwill."

48. But that is not necessarily the case where one is not dealing with actual goodwill but with a case of valuation by the profits method, as I will try to explain.

VPGA 4

49. VGPA 4 is, in my judgment, clear that (like other methods of valuation) what it is aiming at is a valuation of *property* (i.e. a freehold or leasehold interest). The profits method of valuation is guidance on *how to value* property of a particular type. VGPA is replete with references to the valuation of property (emphasis added in the following quotations):

i) "Certain trade related *properties* are valued using the profits *method* (also known as the income approach) of valuation." (para 1.1) What is valued is the property; how to value it is the method.

ii) "This VPGA relates only to the valuation of an individual *property* that is valued *on the basis* of trading potential." (para 1.2) What is valued is the individual property; how you value it is on the basis of trading potential.

iii) "the value of the *property interest* is *intrinsically linked* to the returns that an owner can generate from that use. The value therefore reflects the trading *potential* of the property." (paras 1.3) The value of the property and the potential returns are intrinsically linked. It must therefore be impermissible to separate them.

iv) The profits method "involves estimating the trading potential rather than adopting the actual level of trade under the existing ownership, and it excludes personal goodwill." (para 2.10). Thus, whereas in the case of goodwill attaching to an actual business it is unhelpful to subdivide it, VGPA 4 specifically requires the exclusion of personal goodwill. This is reinforced by para 2.9.

v) Trading potential is "the future profit, in the context of a *valuation* of *the property* that an REO would expect to be able to realise from occupation of the property. This could be above or below the recent trading history of the property. It reflects a range of factors (such as the location, design and character, level of adaptation and trading history of the property within the market conditions prevailing) that are *inherent to the property asset*." (para 2.13)

vi) "To assess the *market value of the property* the FMOP is capitalised at an appropriate rate of return reflecting the risk and rewards of the property and its trading potential". (para 3.1 Step 4 a).

50. All these passages stress that what is being valued is the property asset, how to value it is by the profits method, and the inclusion of trading potential as part of that property valuation reflects value that is inherent in the property asset itself. Trading potential refers to future profits, rather than actual profits. That potential is available to any reasonably efficient operator who acquires the property. On the basis that goodwill is what brings in custom, it will be reflected in the turnover and the profit of the actual business. Yet it was common ground that the valuation by the profits method was based on the market's perception of fair maintainable trade and fair maintainable operating profit; and that that method of valuation applied both to freehold and leasehold property. Even if no business is being conducted on the property, the profits method is still the appropriate way to value it, as section 7 of VGPA 4 explains.

51. Put shortly, VPGA 4 does not recognise the concept of "transferable goodwill" as an asset separate from the property interest. It does, however, recognise "personal goodwill" which is excluded from the valuation under para 2.10. Apart from that personal goodwill, VPGA 4 does not refer to goodwill at all.

52. Moreover, as the decision in *Muller* illustrates, in a very broad sense goodwill attached to an actual business can include the gravitational pull exerted by the location of the property which is an intrinsic feature of the property itself. The location and physical features of the property, whether or not they exert gravitational pull, are part of the value of the property itself.

53. Mr Firth, for the taxpayers, placed some reliance on the decision of Mr Michael Tildesley, sitting as a Special Commissioner, in *Balloon Promotions Ltd v Wilson* [2006] STC (SCD) 167. That, however, was a very different case. A number of franchisees of Pizza Express occupied leasehold property from which they operated Pizza Express restaurants. They entered into agreements to sell the leases and the business to Pizza Express which wished to run the restaurants "in-house". The overall consideration paid by Pizza Express was apportioned. The various leasehold interests were ascribed values from nil to £245,000. Part of the overall consideration was described as "goodwill not adherent in the property" and part as "personal goodwill". The franchise agreements were also terminated and the franchisees entered into restrictive covenants. HRMC did not challenge the leasehold valuations. The issue between the parties was whether, as the taxpayers said, the part of the consideration described as goodwill was indeed a payment for goodwill; or whether, as HMRC asserted, it was in reality compensation for the termination of the franchise agreements. If the former, then the payment was made for an asset and attracted roll-over relief; if the latter, then it did not.

54. Because the valuation of the leasehold interests was not in issue, the question, was whether the payment was made for an asset at all; not for which asset it was made. The Special Commissioner decided that the payments were indeed payments for goodwill rather than for the termination of the franchise agreements. The Special Commissioner examined a number of authorities about the meaning of goodwill, and also expressed some reservations about the then current guidance issued by the RICS on the valuation of restaurants, bars, public houses and nightclubs. But his reservations were expressed in the context of his approach to goodwill, not in relation to the valuation of property. In this case, by contrast, it was common ground on this appeal that VPGA 4 was the correct way to value the leases.

55. What clearly troubled the UT was its perception of the apparent mismatch between the experts' agreement that the passing rents were market rents on the one hand, and the experts' agreement that the leasehold interests had substantial capital value even at those rents, on the other.

56. Mr Firth submitted that the correct way to value was to apply step 4 c in the case of a leasehold interest; and that step 4 a was restricted to freeholds. Once the valuer had assessed market rent in accordance with step 4 c, that was the end of the exercise. VPGA 4 had no further part to play. It made no reference to the capital value of leasehold interests. The hypothetical tenant would pay the market rent in order to acquire the leasehold interest; and that was all that he needed to pay. If and in so far as he paid more, it must have been for something else. Whether you called that "transferable goodwill" or something else did not matter. The point was that it was not paid for the lease. He relied on a passage in the cross-examination of Mr Rodrigues which, he said, showed that she agreed that value of a lease at the market would be nil:

> "Q. My question was very – quite – quite concise. Given the steps we have been through, given the terms of the guidance, and what you have agreed this guidance says, applying those principles, and what this guidance says, the value of a market rent lease is nil, is it not?
>
> A. It is not provided for, no, within this guidance.
>
> Q. Try again. Given this guidance, and what we have – what we have just read, and what you have understood the value of a market rent lease, according to this guidance, is going to be nil, is it not?
>
> A. According to this guidance."

57. I do not consider that that is a complete or correct reading of VPGA 4. Step 4 c is directed towards the assessment of market rent. But what is in issue in this case is not the market rent, but the capital value of the leasehold interests. Step 4 a is not explicitly restricted to freehold interests; and there is no reason why it should be. On the contrary, the definition of market value in para 2.7 of VPGA 4 deals in very general terms with an "asset or liability". If, for example, the passing rent were less than the market rent the value of the leasehold interest would be valued in accordance with step 4 a. An adjustment would need to be made to the definition of fair maintainable operating profit, because that is defined as "level of profit, stated *prior to* depreciation and finance costs relating to the asset itself (*and rent if leasehold*)". That is the adjustment that both experts agreed was the appropriate adjustment to make.

58. In addition, when one is concerned with an open market capital value, the market consists of all those who are willing to buy. The market rent, on the other hand, is concerned only with a transaction between landlord and the tenant. The fact (if it be the fact) that the landlord could not have extracted a higher rent from the tenant does not entail the further proposition that an assignee of the lease would pay nothing for the lease; especially where, as the experts agreed in this case, the passing rent was at the lower end of the range that could have been expected at the valuation date, and the agreed figures for fair maintainable trade and fair maintainable operating profit were higher than the figures actually achieved by the taxpayers.

59. Quite apart from that, the rubric at the head of VPGA 4 says in terms that it does not cover every circumstance; and although it does not specifically deal with the capital value of leasehold interests, there is no reason to suppose that a modified version of step 4 a is inappropriate. On the contrary, the experts agreed that it was the right way to value. Both valuers assessed fair maintainable operating profit after the deduction of rent as recorded in their agreed report; and Mr Firth did not suggest that they were in error in doing so. That was no more than the adaptation of VPGA 4 to the specific facts of the case.

60. Mr Firth also attempted to show, by reference to further passages in the cross-examination of Ms Rodrigues, that she had made the valuation assumption that the hypothetical purchaser of the leasehold interest would also acquire the businesses being carried on at the leasehold properties. In my judgment, however, she did no

such thing. She clearly rejected the suggestion that she had valued anything other than trading potential (which she regarded as another name for what others called "transferable goodwill"). She also said that she had valued on the basis that there was a business in existence on the valuation date, which accords with what the UT itself decided at [95] and also accords with VPGA 4. But she plainly rejected the suggestion that she was trying to value the business and the property together. In so far as she considered the question whether the existing staff structure had any value, what she did was to evaluate the *perception* of the hypothetical purchaser rather than make any *assumption* about transfer of staff. That perception was no more than that it was likely that staff would "go across." As she put it:

> "I haven't assumed that they'll go across, I've assumed that a purchaser of that leasehold interest is [likely] to view that they will stay at the property. That's what I've assumed.

61. Mr Firth also submitted that even an average business could generate goodwill, and that Ms Rodrigues had wrongly taken that goodwill into account. But at the same time, he accepted that Mr Rodrigues had made no error in assessing the fair maintainable trade or the fair maintainable operating profit. Indeed, since those figures were agreed, it is difficult to see how Ms Rodrigues could have been wrong.

62. As I have said "transferable goodwill" is not a concept that features in VPGA 4. It is, however, a term used in the previous guidance issued by the RICS, namely GN 1. But as the UT correctly decided, by the time of the UT hearing, GN 1 had been superseded by VPGA 4. At [113] the UT said:

> "Although GN1 did not apply to going concern or business valuations it nevertheless recognised at paragraph 4.4 that a valuation of a TRP on the basis of market value "should only reflect the transferable goodwill that relates to the trading potential of the property." It is clear from that statement that a market valuation of a TRP could include transferable goodwill and that a property's trading potential was not necessarily only reflected in the value of the interest in land. This passage is not repeated in VPGA 4 which we note does not refer to transferable goodwill."

63. But, in my judgment, an examination of GN 1 shows that the expression "transferable goodwill" does not denote an asset separate from the property interest itself. GN 1 defines "transferable goodwill" as follows:

> "That intangible asset that arises as a result of property-specific name and reputation, customer patronage, location and similar factors, which generate economic benefits. It is inherent to the specialized trading property and will transfer to a new owner on sale."

64. There are a number of points to be made about this definition. First, it is property-specific, not business specific. Second, the goodwill referred to is inherent in the property; in other words it forms part of its value. Third, it "will" transfer to a new

owner on sale. It is not "transferable" in the sense that it is merely capable of transfer; it automatically transfers with the property itself.

65. The error of law which, in my judgment, the UT made was to disaggregate property value on the one hand, and "transferable goodwill" on the other. VPGA 4 is aimed at the valuation of property interests. That they are valued by reference to trading potential does not mean that two separate assets are being valued. As Mr Trott said in *Mohammed* the profits method of valuation does not produce a separate property value distinct from the value of the business use which is conducted from the property. The two are "inextricably linked" as, indeed VGPA 4 itself states in paragraph 1.3. The error that the UT made was in attempting to extricate the value of the business use from the property value.

66. In so far as there is a concept of transferable goodwill of a hypothetical business, it is simply part of the inherent qualities of the property itself and its trading potential, as stated in VGPA 4 para 2.13. There is only one asset, namely the property, and the profits method of valuation is, as its description implies, no more than a method of arriving at the value of the property.

Result

67. I would allow the appeal. It was common ground that if we found that the UT did make an error of law in ascribing value to "transferable goodwill" (as I have held that they did), we should re-make the decision ourselves. On that basis, I would determine the open market value of the leasehold interests in the sums agreed by the experts:

a) Manor Place: £730,000;

b) Maple House: £542,500.

Lord Justice Warby:

68. I agree.

Lord Justice Snowden:

69. I also agree.