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Dear Sirs

**IVSC DISCUSSION PAPER
THE VALUATION OF TRADE RELATED PROPERTY**

HMRC Shares & Assets Valuation (SAV) and the Valuation Office Agency (VOA) are, amongst other things, responsible for advising HMRC on valuations of properties for tax purposes and the value of businesses operated from trade related properties.

We see very significant numbers of trade related property valuations and have been acutely aware of both the confusion and debate that follows this sector of property where a profits approach to property valuation is regularly misinterpreted.

We have been active in discussions with both the Chartered Institute of Taxation (CIOT), the Royal Institution of Chartered Surveyors (RICS) and others, on the approach and assumptions to be made when valuing Trade Related Properties for various tax purposes.

We consider the RICS Valuation Standards Guidance Note 2 the 'Valuation of Individual Trade Related Properties' and other RICS guidance, has assisted much needed clarification here and provides to a large extent, the guidance and clarity needed.

We are keen to ensure clarity of understanding and consistency in valuations of trade related properties and the apportionment of prices paid for businesses operated from trade related properties. The responses below represent the views of both HMRC and the VOA.

Our responses to the questions raised in the discussion paper are as follows:-

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Question 1

a) Are you familiar with the former GN12?

Yes.

b) Is GN 12 used in the valuations that you provide or receive?

Valuation reports that we receive from taxpayers have usually been carried out by RICS valuers who do not specifically make reference to GN12. The reports we see usually make reference to the RICS Valuation Standards Guidance Note 2 (RICS GN2) which contains clear and more detailed guidance on the principles and concepts covered.

c) If you have answered yes to either of the above, what are the elements of GN 12 that you find useful in either reporting or interpreting valuations?

The only element of GN12 that we find useful in interpreting the valuations we receive is the use of the concept of Reasonably Efficient Operator (REO) which is similar to that in the RICS GN2. There are some elements of the current GN12, for example the use of the term 'transferable goodwill' (paragraph 3.3.3) and 'the manager' (paragraph 5.5), that lead to confusion amongst valuers as to whether they are supposed to be valuing the property only or the business. In our view RICS GN2 provides greater clarity and detail on the particular issues that arise when valuing individual trade related properties and makes it clear that a valuation in accordance with RICS GN2 is not a valuation of the business. IVS 232 could be an improvement on GN12 with some limited but important modification (the reference to operating unit, is inconsistent with the operational entity within GN2). To avoid inconsistency, we would suggest direct reference back to RICS GN2, or use of the same principles and definitions.

Question 2

Do you consider that it is a) practical and b) necessary to define a distinct category of real property for valuation purposes based on the degree to which the buildings or any other structures are specialised?

We consider that it is both practical and necessary to provide some definition of TRP for valuation purposes to explain the differences with other types of property. The valuation considerations for TRPs are distinct not only because the buildings are designed (or adapted) for a specific type of business use but also because they are bought and sold in the market based on their trading and income generating potential for that type of use. TRPs are bought and sold in the market based on their trading potential (even when new or vacant) because the buildings are usually to some degree unique (in terms of their location, character, size, planning, level of adaptation or construction) and consequently there is a lack of directly comparable evidence. TRPs are different from other classes of property in that it is the use of the specific land and buildings that is the underlying source of income generation. In almost all types of TRP the customers to some degree 'occupy' the property whilst they are enjoying whatever service the business provides, e.g. a pub, hotel, care home, cinema, golf course etc.

Of course not all TRPs will occupy specialised buildings, some TRPs may comprise buildings that are suitable for other uses and some of those may comprise buildings that have been adapted for such use (for example a restaurant in a retail parade). When estimating the market value of a TRP that is suitable for other uses the valuer must consider the likely bids of any purchasers for competing uses. Similarly when valuing a TRP that comprises a building that has been adapted for such use and similar unadapted premises are available nearby, then it may be necessary to consider whether the bid of a purchaser would be influenced by how practical it would be to acquire a similar nearby building and adapt it.

However, the approach to valuation cannot be prescriptive and must reflect the specific facts and circumstances. It has to be acknowledged that use of the profits method of valuation, that may underpin many other comparative approaches, is one of a range of valuation approaches to estimate the market value of a property and is not restricted to TRPs. It may sometimes be appropriate to value some specialist or unique properties that are used for industrial or retail purposes using the profits method if the valuer considers that is how a purchaser in the market would calculate their bid. As outlined above, in our view, it is for the valuer to consider the appropriate valuation method having regard to the facts of the case.

In our view any definition of TRP needs to go no further than the current broad definition contained in the RICS GN2. The definitions cannot be prescriptive or exhaustive for the above reasons. However, it is important to acknowledge that TRPs are generally valued by the profits method and then provide valuers with clear guidance on the application of the profits approach to such properties. To ensure that valuers produce consistent valuations we believe that it is essential that there is an understanding of the types of property that it will normally be necessary to value using the profits approach and a clear understanding of the application of the profits approach to property valuation. Clarity is essential so that there is no confusion amongst valuers about what is included in a valuation of a TRP. The guidance on the application of the profits approach to property valuation can of course be followed by valuers when valuing other types of specialist or unique industrial or retail properties if the valuer considers a profits approach is appropriate.

Question 3

If you have answered yes to Question 2, do you consider that the term “Trade Related Property” adequately conveys the particular characteristics that may lead a valuer to adopt a different valuation method as compared to other types of property?

In our view the term ‘trade related property’ adequately conveys the particular characteristics that may lead a valuer to adopt a different valuation method as compared to other types of property. The term is widely used and understood. Any confusion is not around the term ‘trade related property’ but relates to wider misunderstanding (including some valuers) of the profits approach to property valuation and what is included in a valuation of a TRP. We believe that the RICS GN2 provides the required clarity. [For this reason we are concerned that the introduction of the term ‘operating unit’ in IVS232 is confusing - does it mean the going concern (all assets including property), or just the property on the basis of an operational entity as defined in GN2?]

Question 4

If you have answered yes to Question 2, please also indicate the types of real property that should be included in distinct category.

The types of real property that should be included in this distinct category include hotels, pubs and bars, restaurants, care homes, petrol filling stations, nightclubs, casinos, cinemas, theatres and most other types of leisure property such as golf courses, amusement parks etc. However, it is not in our view appropriate to try and provide an exhaustive list of examples of TRPs because whether or not a building is designed (or adapted) for a specific type of business use and bought and sold in the market based on the trading potential for that type of business, will depend on the facts of each case. Whether a building is a TRP is ultimately a question of valuer judgement based on the particular facts, as is the most appropriate means of determining the market value.

Question 5

If you have answered no to Question 2, are there any other characteristics other than the specialisation of the buildings or structures that you believe may require Trade Related Property to be separately categorised from other real property for valuation purposes?

As indicated in our answer to question 2 above, TRPs are in our view distinct not only because the buildings are designed (or adapted) for a specific type of business use but also because they are bought and sold in the market based on the trading potential for that type of business. Unlike other properties, it is the property itself and customers use thereof that is the predominant source of underlying income generation.

Question 6

Are you familiar with the “profits method” as outlined above to value TRP? If so please indicate the types of real property where you are familiar with its application.

We are very familiar with the profits method of property valuation for all types of TRP, examples of which are given in our answer to question 4 above.

In our view some business valuers who are not familiar with property valuation fail to understand the distinction between the profits method of property valuation and a valuation of a business using a similar profits approach.

If the principles in the RICS GN2 are followed we believe valuers should arrive at the value of TRP as an ‘operational entity’ to a ‘reasonably efficient operator’ (REO). This is a valuation of the property, reflecting established or future trading potential that will run with or attaches to the property, and is properly reflected in the market sustained bid for such, on a sale or transfer.

It is in our view absolutely clear that a valuation of the property under RICS GN2 does not reflect the value of the current occupier’s brand, it does not reflect the current occupier’s skills and it is clearly distinct from a valuation of a business as a going concern.

We believe that there is a broad measure of agreement across the valuation, accountancy and legal professions that the value of goodwill is represented by the difference between the value of a business as a going concern and the value of the separately identifiable assets included in the sale. If so, then the value of the property cannot also be a residual value as is suggested in paragraph 11 of the discussion paper.

Question 7

What methods do you normally use to allocate value to the real property interest? Do you apply the same method regardless of the type of real property involved?

For TRPs, a RICS GN2 valuation of an operational entity only includes the legal interest, trade inventory and trading potential with an assumed ability for the purchaser to renew or obtain necessary licences or consents. It is our view, confirmed by GN2 at s 1.3 and 7.2 this is a valuation of the real property from which chattels can be allocated by reference to their contribution in situ if required.

This is distinct from the price paid for a going concern that includes the property and other assets that might include the former operator’s business (perhaps with some additional value from specific contracts).

When it is necessary to apportion the value or the sale/purchase price paid for a business as a going concern for tax purposes, we follow the method set out in the HMRC/VOA Practice Note ‘Apportioning the Price Paid for a Business Transferred as a Going Concern’ which is available at <http://www.hmrc.gov.uk/svd/practice-note.pdf> Some revision of this Practice Note is under consideration as part of ongoing discussions between the HMRC/VOA and the CIOT.

As explained in the Practice Note, exactly what is required depends on the particular statutory provisions.

When an apportionment is required (e.g. for the purposes of Stamp Duty Land Tax) we follow the following five step method:

- Step 1 - We estimate the market value of all the tangible assets (property, licences and chattels) together as an 'operational entity' (following the principles now set out in the RICS GN2).
- Step 2 - We identify the sum attributable to goodwill and any other intangible assets included in the sale by deducting the value of the property, licences and chattels (Step 1 value) from the sale price or market value of the business as a going concern.
- Step 3 - We identify the sum attributable to the chattels by estimating their 'in-situ' value (i.e. the value to an incoming purchaser not their value if sold separately from the property).
- Step 4 - We identify the sum attributable to the real property interest by deducting the value of the chattels (Step 3 value) from the Step 1 value.
- Step 5 - We stand back and consider whether the answer produced by the above approach is reasonable in the particular circumstances of the case.

When it is necessary to calculate the cost of purchased goodwill for the purposes of Part 8 of the Corporation Tax Act 2009 (CTA 2009) we are required to follow accounting guidance and Financial Reporting Standard (FRS) 10 provides that 'purchased goodwill' should be taken to be "the difference between the cost of an acquired entity and the aggregate of the fair values of that entity's identifiable assets and liabilities" (i.e. goodwill is recognised for accounting purposes as a 'residual'). In HMRC's view, based on guidance in FRS 15, for TRPs it is necessary to deduct the 'Existing Use Value' of the tangible fixed assets and this is represented by the market value of the assets as an 'operational entity' in accordance with the guidance contained in the RICS GN2. (A more detailed analysis of the accounting provisions, which is not currently included in the HMRC/VOA Practice Note, is attached as Appendix A.)

Although the HMRC/VOA Practice Note is directed at apportionments involving TRPs, because that is where most confusion seems to arise, we consider that, in principle, the methods set out in the Practice Note are equally applicable to other types of property.

Question 8

In your experience what sources of data are available to support the use of either the profits method or an allocation to the real property from the value of the business in occupation? How reliable are these?

In our experience the use of the profits method to 'value' property can be supported by an analysis of the data relating to actual market transactions involving both sales of empty properties and sales of properties as part of a going concern. The analysis of the available data and its application to the particular facts of the valuation under consideration do of course, like any valuation, require the valuer to exercise their skill and judgement and to be clear as to exactly what is being valued.

There is in our view no reliable data to support an alternative 'allocation' to the real property. Sometimes allocations or apportionments of going concern values may be agreed between the parties to a sale but these are often influenced by their respective tax positions and there are wide variations in approach. Some of the allocations or apportionments we see are often based on hypothetical valuations of the property made on special assumptions that do not reflect the actual facts (e.g. the property is valued on the assumption that it has been

stripped of chattels and left empty for a period of time when that is contrary to the facts). We believe the only realistic method of allocation requires a valuation of the property interest, reflecting the facts and circumstances prevailing and the trading potential that will run with property, which when deducted from the going concern price paid, will identify any additional sum paid for other assets. This has to be preferable to an arbitrary and artificial allocation that bears no relation to the facts.

In our view valuers need some guidance to ensure a consistent and logical approach to any apportionment or allocation.

Aside from it being the HMRC/VOA view that the approach outlined in the Practice Note is reliable, it is also our view that that the approach through its relative simplicity, can also reduce costs for taxpayers. This is on the basis that the majority of cases that HMRC/VOA enquires into involve smaller businesses operating through a single TRP where other intangible assets such as brands are not often a feature. HMRC/VOA believe that the Practice Note provides the most cost-efficient and reliable route to resolving the relatively straightforward valuation issues usually involved. As outlined at Section 6 of the Practice Note, the level of simplicity involved provides for a relatively limited role for HMRC SAV in most instances and therefore this should reduce costs for taxpayer's if their advisers follow the guidance in the Practice Note.

Question 9

Do you consider that the general provisions in the IVSs concerning identification of the asset to be valued and clarification of the assumptions made about complementary or associated assets are sufficiently clear for application to TRP or do you believe that the IVSs should provide more specific guidance? If you believe that more specific guidance is required, please indicate the types of TRP where you believe that this is needed.

Although the general provisions in the IVSs, referred to in paragraphs 13 and 14 of the discussion paper, are clear, in our view valuers of TRP do need more detailed guidance.

We believe the guidance contained in RICS GN2 provides the necessary additional clarity about the asset to be valued and the assumptions made about complementary or associated assets for all types of TRP.

Question 10

Please indicate any techniques with which you are familiar for ensuring that the value of the real property interest excludes any value attributable to other assets.

In our view the guidance contained in the RICS GN2 provides an acceptable approach for arriving at the value of the real property interest if it were sold as an 'operational entity' together with the 'trade inventory' (i.e. chattels etc). The value of the chattels can then be readily stripped out of this figure by deducting their 'in-situ' value (see 'Step 3' in our answer to question 7 above) to leave the value of the property interest.

RICS GN2 makes very clear what is being valued under the definition of the 'operational entity' at paragraph 2.8 and provides clear direction under section 5.

Question 11

Please indicate for what purposes you consider that a valuation of a TRP should be made on the assumption that it is part of a going concern and for what purposes it should be made on the assumption that there is no business in occupation.

In our view, any valuation must follow the facts.

If a TRP is sold as part of a going concern then the property should be valued on the assumption that it could be sold as part of an 'operational entity' together with the trade inventory, in accordance with the RICS GN2.

If a business is valued as a going concern then this will include the property and the value allocated to the property should be arrived at along the lines indicated in our answer to question 7 above.

The property should only be valued on the assumption that it is empty and stripped of chattels if that is the reality at the valuation date.

There appears to be a common misconception that the value of a property can be represented by its 'bricks and mortar' components. This is misleading. The 'market value' of any property reflects a wide range of 'hard' and 'soft' factors that include (as examples) prevailing market conditions, customer 'taste' and patronage, stigma, and trading potential.

Question 12

Do you agree that the value of the real property interest is affected by whether or not there is a business in occupation?

In our view the value of the real property interest may be affected by whether or not there has been a business in occupation up to the valuation date. Again this should be a question of prevailing facts and circumstances.

A TRP will often be worth more to an incoming purchaser if there has been an existing customer base frequenting or using the premises, a proportion of which are likely to continue to do so on any transfer to another purchaser assuming they continue to use the property for similar purposes. If a purchaser considers there will be an element of users that will stick with the property, and the purchaser can acquire all the chattels together with the property to enable them to trade from day 1, this will be beneficial and properly part of the property asset value at that point.

A TRP that has been stripped of chattels and empty for a long period will usually be worth less because the incoming purchaser cannot trade from day 1 (because they have to allow time to fit the property out) and when they do commence trading it may take time to build trade up to the expected level because customers have taken their custom elsewhere whilst the property has been empty. The incoming purchaser may also incur additional advertising costs whilst trying to build up the level of trade to expected levels.

This in principle is no different to the level of passing trade impacting different established retail values that vary with established and changing customer footfall.

The market value of a property is not fixed by the structure alone, but evolves and changes with circumstances, facts and conditions. The fact that a TRP has been operational and open with established customer patronage up to point of transfer is a fact that does affect property value.

The value of any real property interest should of course normally reflect the effect on value of any leases or licences to third parties in place at the valuation date, and these may enhance or depreciate the value of the property depending on the facts.

Question 13

If you are a user of valuation reports, in your experience, is the distinction between the business and the property interest normally clear from the reports that you receive?

In the past the distinction between the business and the property has not always been clear in some valuation reports despite a clearly stated purpose. We believe that if valuers follow the guidance now contained in the RICS GN2 there should no longer be any confusion.

Question 14

If you are a provider of TRP valuations, what steps do you take to distinguish the business from the real property interest?

When we carry out any valuations we would normally follow the guidance in RICS GN2, or for tax apportionments we would follow similar principles (see our answer to question 7 above). In our view the RICS GN2 makes it clear that a valuation of the property and chattels together as an 'operational entity' to an incoming purchaser does not include any additional value that the existing business in occupation at valuation date may have.

If you have any queries regarding any of the above comments please let me know.

Yours faithfully,

Paul Simpson
Assistant Director

IVSC Discussion Paper – The Valuation of Trade Related Property Comments from HMRC/Valuation Office Agency

APPENDIX A

Part 8 CTA 2009 cases – accountancy definition of goodwill

1 For the purpose of calculating the cost of purchased goodwill Part 8 CTA 2009 provides that ‘goodwill’ has the meaning it has for accounting purposes. UK GAAP (FRS10 *Goodwill and intangible assets*) provides that ‘purchased goodwill’ should be taken to be the "difference between the cost of an acquired entity and the aggregate of the fair values of that entity’s identifiable assets and liabilities. Positive goodwill arises when the acquisition cost of the entity exceeds the aggregate fair values of the identifiable assets and liabilities. Negative goodwill arises when the aggregate fair values of the identifiable assets and liabilities of the entity exceed the acquisition cost". Thus, purchased goodwill recognised for accounting purposes is a ‘residual’¹. For the avoidance of doubt, purchased goodwill only arises for accounting purposes where there has been a business acquisition.

2 UK GAAP (FRS 7 *Fair values in acquisition accounting*) requires fair values to be used in measuring the identifiable assets and liabilities of an acquired business at the date of acquisition and that the identifiable net assets which should be recognised (as forming part of the business combination) to be measured at fair values that reflect conditions at the date of acquisition.

FRS 7, para. 9 requires that the fair value of a tangible fixed asset should be based on:

- a. market value, if assets similar in type and condition are bought and sold on an open market [as here]; or
- b. depreciated replacement cost [generally not applicable here].

3 In determining what is meant by ‘market value’ within FRS 7, FRS 15 (*Tangible fixed assets*) is instructive, paragraphs 53 and 56 in particular (notwithstanding they are in the section of the standard dealing with revalued properties). FRS 15 is authoritative literature which explains what is meant by ‘market value’ in the context of valuing property. Paragraph 85 also provides support that for TRPs trading potential is reflected within the value of, and is inseparable from, the property.

- FRS 15, para. 53 (inter alia) states:

“The following valuation bases should be used for revalued properties that are not impaired:

- (a) non-specialised properties should be valued on the basis of existing use value (EUV) ...”.

¹ IFRS 3, (Appendix A) defines goodwill as: “[a]n asset representing the future economic benefits arising from assets acquired in a business combination that are not individually identified and separately recognised”.

- FRS 15, para. 56 states:

“Certain types of non-specialised properties are bought and sold, and therefore valued, as businesses. The EUV of a property valued as an operational entity is determined by having regard to trading potential, but excludes personal goodwill that has been created in the business by the present owner or management and is not expected to remain with the business in the event of the property being sold”.

- FRS 15, para. 85 states:

"It would not be appropriate, however, to treat the trading potential associated with a property that is valued as an operational entity, such as a public house or hotel, as a separate component where the value and life of any such trading potential is inherently inseparable from that of the property".

Therefore, for non-specialised properties (which include TRPs), HMRC considers the use of an EUV basis of valuation is required by UK GAAP in the context of the fair value exercise in a business acquisition.

- 4 For companies preparing accounts under IFRS², the relevant accounting standards are IFRS 3 (*Business Combinations*), IFRS 13 (*Fair Value Measurement*) and IAS 16 (*Property, Plant and Equipment*). In general, though in particular circumstances there may be exceptions (e.g. market value and fair value may not be the same), it is not considered likely in relation to TRPs there will be substantial differences between accounts drawn up under UK GAAP and IFRS (unless, in IFRS, market or other factors suggest that a different use by market participants would maximise the value of the asset).
- 5 ‘Negative goodwill’ (i.e. a gain resulting from a bargain purchase) can arise, under both UK GAAP and IFRS. Within UK GAAP, negative goodwill is carried on the balance sheet and recognised in the profit and loss account in the periods in which non-monetary assets are recovered (by depreciation or disposal) or in which the benefits are expected to be realised. Within IFRS, however, the gain resulting from a bargain purchase is recognised in profit or loss on the acquisition date.
- 6 In HMRC’s view, for TRP, the EUV of the tangible assets required for the purpose of calculating the cost of purchased goodwill under Part 8 CTA 2009 will normally be represented by the market value of the assets as an operational entity, in accordance with the guidance contained in the RICS Red Book GN2.

² International Financial Reporting Standards.