

CAPITAL GAINS TAX – Accountancy Partnership Practice – Admission of new partners on purchase terms – Subsequent attempt by the new partners to dissolve the partnership and to recover from the original partners the sums which the new partners paid by way of purchase – Claim by the new partners that the sums which they paid were premiums – Claim by the Appellant that what the new partners purchased was a share of goodwill – High Court proceedings instituted by the new partners in an attempt to recover the sums which they had paid for admission to the partnership – The Appellant defended the proceedings maintaining that the payments were made for a share of goodwill and not as a premium – Claim by the Appellant that the legal costs which he incurred in defending the High Court action brought against him by the new partners constituted "expenditure wholly and exclusively incurred by him in establishing, preserving or defending his title to, or a right over, the asset", namely his goodwill – Section 38(1)(b) Taxation of Capital Gains Act 1992 – Appeal allowed

THE SPECIAL COMMISSIONERS

MR BRIAN LEE Appellant

- and -

MR M J JEWITT, OBE

(HM INSPECTOR OF TAXES) Respondent

Special Commissioner: MR T H K EVERETT

Sitting in London on 16 August and 8 September 2000

Elizabeth Wilson of Counsel, instructed by Messrs Hawkings Ross, Solicitors for the Appellant

The Respondent in person

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DECISION

Mr Brian Lee ("Mr Lee") appeals against a capital gains tax assessment for the year 1981/2. Certain of the items contained in the assessment are agreed and not relevant to the issues in this appeal. The sole issue in this appeal is whether the legal costs which Mr Lee incurred in defending an action brought against him by his former partners in his Accountancy Practice fall within section 38(1)(b) Taxation of Capital Gains Act 1992 as "expenditure wholly and exclusively incurred by him in establishing, preserving or defending his title to, or a right over, the asset", namely his share of the goodwill of his partnership accountancy practice.

Mr Lee contends that in defending the action brought against him by his former partners he was defending his title to his share of the goodwill of his partnership accountancy practice. The Respondent Inspector contends that in defending the action brought against him Mr Lee was defending his right to retain the cash

sums paid to him by his former partners and that such sums were paid to him as a premium and not for a share of goodwill.

The evidence before me consisted of an agreed Statement of Facts and Issues supported by the sworn testimony of Mr Lee and that of his solicitor Mr Alastair Neil Ross, who acted for Mr Lee in the High Court action instituted by Mr Lee's former partners.

In addition an agreed Bundle of Documents was put in evidence.

From the evidence before me I find the following relevant facts:

1. Mr Lee and David Cameron Little had been partners in an accountancy practice since 1979. On 22 April 1981 three new partners were admitted to the partnership. They were Clive Faulkner Owen, Neil Irving Coulthard and Alan Richard Neal. The terms of their admission are contained in a partnership agreement dated 22 April 1981, a collateral agreement of the same date and an interpretation letter also dated 22 April 1981.

Each of those documents was signed by all five of the parties thereto.

2. The new partners paid £150,000 to the old partners for 20% of what was described in the agreements as "goodwill". Mr Lee received half of this amount, namely £75,000. Mr Little received the other half.

3. Following partnership disagreements, the new partners sought to dissolve the partnership and issued proceedings in the Chancery Division of the High Court at Newcastle against Mr Lee. The relief they sought was the repayment by Mr Lee of the £75,000. The new partners sought this relief on the basis that the £75,000 was a premium, not a payment for goodwill, and as a premium it was returnable on the dissolution of the partnership. To support their contention the new partners produced expert evidence that the goodwill was worthless as at 22 April 1981 and therefore the £75,000 must have been for something else, i.e. it must of been a premium.

4. Mr Little gave his support to the new partners' arguments that the £150,000 had been a premium, not a payment for goodwill. However, he did not give evidence at the trial of the action.

5. Mr Lee denied that the £75,000 was a premium. He relied upon the terms of the agreements dated 22 April 1981 and also produced expert evidence that the goodwill was not valueless as at 22 April 1981.

6. The action was heard on 24 and 25 February 1983. It was settled on 25 February 1983 after the judge gave his opinion that on the evidence before him the payment was for goodwill, and not a premium. The settlement involved the immediate dissolution of the partnership without repayment of the £75,000. The pleadings in the action were not available evidence before me as, on the testimony both of Mr Lee and of Mr Ross, some copies had been mislaid and the rest destroyed.

7. On the evidence both of Mr Lee and Mr Ross, which I accept, the new partners argued in the Chancery action that the goodwill of the partnership was "valueless" as at 22 April 1981. Mr Ross stated in evidence before me that if the goodwill was valueless, it didn't exist. There was no attempt by the new partners in the

proceedings launched against Mr Lee to contend that they had paid too much for entry into the partnership in 1981. Their argument was simply that the goodwill was valueless, therefore there was no goodwill for them to purchase and accordingly they must have paid a premium to enter the partnership and did not purchase a share of the goodwill.

8. Prior to the action between the new partners and Mr Lee, the solicitors for two of the new partners, Messrs Coulthard and Neal, wrote to Mr Lee on 14 July 1982. Their letter includes the following paragraphs:

"We have been instructed by Mr Neil Coulthard and Mr Alan Neal to advise them in connection with the present partnership difficulties, which we understand all partners acknowledge exist. Our clients are extremely anxious about the future of the partnership, which is a fixed term partnership for five years from 1 May 1981.

We think it is common ground between the partners that the problems which do exist concern the relationship between you and David Little. We further understand that it has been suggested that a meeting should take place between you and Mr Little to consider, among other things, the present partnership difficulties. If this is the case, the proposal to have a meeting involving you and Mr Little causes our clients concern. The partnership comprises five partners. Our clients have paid in cash the amount for goodwill to you and Mr Little. In the circumstances any discussion on the future of the partnership must involve all of the partners. We accordingly propose that there be a meeting between all of the partners, together with their respective solicitors (if this is considered necessary) to consider the future of the partnership."

9. Some months later on 16 September 1982 the solicitors acting for Mr Coulthard and Mr Neal wrote to the solicitors then acting for Mr Lee. Their letter contains the following paragraphs:

"As you know, we are acting on behalf of Mr Coulthard and Mr Neal. We have discussed this matter with Mr Tate of Messrs Jacksons, Monk & Rowe, who act on behalf of Mr Little. We have also discussed the matter with Mr Baldwin of Messrs Southall & Co who act on behalf of Mr Owen. We are authorised to put forward the following basis for the retirement of your client from the practice:

1. Your client be repaid the amount outstanding on his capital and current accounts as of the date of retirement.
2. Your client repays the premium received by him from Messrs Owen, Coulthard and Neal in accordance with the collateral agreement dated 22 April 1981.

If the proposed basis of settlement is acceptable we propose that these terms take effect on 30 September 1982. In this event the repayment of the premium to Owen, Coulthard and Neal will be 43/60 of £75,000. On 30 September 1982 calculations will need to be made of your client's capital and current accounts. Such calculation will be made as soon as possible. Within 14 days of such accounts being received by your client he will indicate his approval to them. In the event of his disagreement the matter will be immediately referred to an Arbitrator appointed by the President of the Newcastle District of the Northern Society of Chartered Accountants. The decision of such Arbitrator shall be binding on the parties."

10. A letter dated 4 April 1985 written to the Inspector of Taxes by financial and tax advisers to Mr Lee contains the following paragraph:

"Mr Little did not give the verbal evidence at the hearing as he was clearly in some difficulty having earlier joined together with Mr Lee to sell the goodwill for £150,000 and then a relatively short time thereafter turning around and joining with the other partners in an action against Mr Lee to say that the goodwill at the time of purchase by the new partners was in fact valueless."

11. Mr Ross wrote to Mr Lee on 10 October 1985 in the following terms:

"We acknowledge receipt of your notification that the Inspector of Taxes requires sight of the pleadings drawn by Counsel for the Plaintiff and Defendant in the Partnership Action.

We would mention that the Bundle of Pleadings is not much short of a foot thick and the cost of copying and supplying this apart from the sheer mass of paper is quite considerable.

A very large percentage of what is said in the various Affidavits and Pleadings is irrelevant to the point of premium or goodwill.

Perhaps it would suffice for us to say that from our intensive knowledge of the Case, we can confirm that the claim made by your former Partners was to recover the payments of £50,000 a piece made by the three junior partners by alleging that such payments were made as a premium and not made in payment for goodwill.

This was of course the central issue in the Case and without doubt it was necessary for you to contest those Proceedings with, as you know, a successful outcome.

If the Inspector of Taxes requires any further information perhaps you would ask him to contact us and we will do our up most to assist."

12. On 27 October 1997 Mr Ross wrote to the Inspector of Taxes a letter which contains the following paragraph:

"The expert witness for Mr Owen, Mr Coulthard and Mr Neal who is Mr Chilvers of Messrs Coopers & Lybrand in fact argued that there was no goodwill – you stated on the second page of your letter that "no-one disputed that Mr Lee had a title to 20% share of the goodwill" but I had the conduct of this case and as mentioned, Mr Chilvers in fact argued that far from being entitled to £75,000 paid under the Agreement, Mr Lee was entitled to nothing – this is a fact."

13. Mr Lee incurred legal expenses of £13,223.60 in defending the action brought against him by the new partners. This is an agreed figure which is not in dispute.

14. The sole issue in this appeal is whether (as Mr Lee contends), the legal costs which he incurred in defending the action brought against him by the new partners fall within the provisions of section 38(1)(b) of the Taxation of Capital Gains Act 1992, so that it is deductible in computing the gain accruing to Mr Lee on the part disposal of the goodwill.

Conclusions

The Inspector has contended that when the new partners brought an action against Mr Lee they were not challenging Mr Lee's title to the goodwill but rather

to its valuation. He has submitted that Mr Lee was not defending his title to the asset disposed of, "but rather his title to the cash he got for it."

This is a short point and the evidence is entirely in favour of Mr Lee's claim and the submissions put forward on his behalf by Elizabeth Wilson.

The three documents concluded on 22 April 1981 each refer to goodwill. Tellingly, the reference to goodwill is repeated in the letter of 14 July 1982 written by the solicitors acting for Messrs Coulthard and Neal to Mr Lee. That states "our clients have paid in cash the amount for goodwill to you and Mr Little." (My emphasis). It was not until some two months later when the same solicitors wrote to Mr Lee's then solicitors on 16 September 1982 that reference to goodwill is abandoned and the word "premium" is substituted.

In the action before the judge at Newcastle he gave his opinion that the payment was not a premium but was for goodwill.

There is also the clear evidence both of Mr Lee and of Mr Ross that Mr Lee was defending his title to his goodwill, for what the new partners were alleging was that the goodwill did not exist as at 22 April 1981.

The Inspector's submissions depend almost entirely upon his stated rejection of the evidence of the two witnesses before me. I was particularly impressed by the evidence of Mr Ross who had a clear recollection of the action brought against Mr Lee by the new partners. Mr Ross was instructed at short notice after Mr Lee became dissatisfied with the performance of the firm of solicitors which he had instructed originally and it was in fact the first Chancery action with which Mr Ross had dealt. He attended the conferences with Counsel and had no doubt that what he was doing was defending Mr Lee's title to the goodwill of the partnership.

The appeal succeeds and I determine the assessment in the agreed figures of £27,726 less agreed legal expenses of £13,223.60 leaving a balance of £14,502.40.

T H K EVERETT

SPECIAL COMMISSIONER

Date of Release: 4th October 2000

Authorities cited but not referred to in the Decision

C I R v Richards Executors 46 TC 626

The Queen v Everett 1EL&BL 273

Chaney v Watkis [1986] STC 89

Administrators of the Estate of Caton (deceased) v Couch [1997] STC 970

R J Reuter Co Limited v Ferd Mulhens [1953] AER 1160

C I R v Muller & Co Margarine Limited [1901] AC 217

SC 3063/96