
The Personal Tax Planning Review

BEWARE THE HIDDEN DISCOUNT

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There is a trap which can cost a taxpayer considerable sums of CGT, simply because the taxpayer's adviser may not be fully aware of the valuation process.

Suppose a landowner has owned 1200 acres of land since before 1982. Suppose he now gives his son a one half undivided share in the whole estate. The Capital Gains Tax falls to be assessed on the disposal.

What may well happen is that the Inspector of Taxes may ask the District Valuer to assess the value of a half share at the 31st March 1982, and the value of a half share at the disposal date. The computation of the capital gain or loss will then be based on the difference between the two figures, adjusted for indexation and any other allowable expenditure.

This seems simple and straightforward, but it is wrong, and what is more, the error will in practice usually operate in favour of the Revenue.

The reason is that normal valuation practice is to value a part share by taking the value of the whole, dividing it by the appropriate fraction (eg a half) and then deducting a discount which is usually 10%, to reflect the fact that the value of a half share in the open market is worth less than 50% of the full value. Following *Wight v IRC*² the discount will normally be 10% and may be increased to 15% in special cases; but generally a discount between 5% and 15% will be applied whenever a part share is involved.

However, there is a risk that the Inspector may ignore the part disposal rules. Under s.42 TCGA 1992 the familiar A/A+B formula should be applied, in this example, to the value of the whole asset at 31st March 1982, and to any other allowable expenditure.

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² [1982] 264 EG 935

A is the value of the half share given, which will be calculated as one half of the full value less 10%. B will be the value of the half share retained, which will also be calculated as half of the full value less 10%. As the discount of 10% is applied to both top and bottom of the formula it cancels out, and therefore the base value will be calculated from a starting point of precisely half the full 1982 value. The disposal proceeds, on the other hand, in the case of a disposal at deemed market value, will be calculated on the basis of 50% less 10%, ie 45%, thus creating a smaller gain or larger loss in favour of the taxpayer.

This will be seen more clearly by taking the gift by the landowner mentioned above and applying some notional figures to it. Let us suppose that the estate was worth £3,000 an acre at the 31st March 1982. Let us suppose it is worth £1,500 an acre today and assume an indexation factor of (for convenience) 80%.

The value of the whole at March 1982 was therefore £3.6m. The value of the whole today is £1.8m. The value of a half share today is therefore £810,000 (ie half of £1.8m less a discount of 10%). The retained share and the share given are both worth the same amount in this case, and these are A and B in the part disposal formula.

The computation of the base value therefore starts with calculating A over A+B, which equals one half exactly. This is applied to the March 1982 value to give £1.8m which is increased by indexation to produce £3.24m.

The market value of the share which was given is £810,000, as above, and the allowable loss is therefore £2.43m, subject of course to the restrictions on losses created by the indexation allowance which have been introduced by the current Finance Act 1994, and the restriction on the use of losses on a disposal to a connected person contained in s.18(3) TCGA 1992.

If the Inspector had merely asked for a value for a half share at March 1982 then the figure he will have been given is £1.62m (that is, half of £3.6m less 10%). Indexation brings this up to £2.916m, producing a loss of £2.106m. The loss has been decreased by £324,000, thus producing potential additional tax of just under £130,000.

The illustration has been taken with bare land for simplicity's sake, and in view of the current Finance Act the landowner might well choose to include in the gift a number of assets which have appreciated in value such as cottages which have become vacant, barns with development value, or building land. He will no doubt wish, so far as possible, to ensure that the gift he makes can be treated as a gift of a single asset rather than a series of assets, some showing gains and some showing losses. One feels there will be considerable debate over the nature of a single asset following the passing of the Finance Act 1994 and in this connection the CCAB Press Release of June 1998 needs to be read with care.

It will be seen that the accountant must know the full value at March 1982 of the asset as a whole in order to apply the part disposal formula to that value. If the gifted half share is treated as an asset in its own right, then the part disposal formula will not be used at all, and the acquisition cost figure will be discounted before the indexation allowance is applied to it.

As will be seen, if the second half share is then given away and the same happens again, the acquisition cost of both halves will have been discounted by 10%, so that (to take the example above) the March 1982 value will have been devalued from £3.6m to £3.24m. The missing £360,000 can never be used against any later disposal because the whole asset has been given away.

It will be seen that if any misunderstanding of this nature occurs, more tax rather than less is likely to be payable. Either the discount will be applied to both the 1982 value and the gift, in which case the allowable expenditure will be wrongly reduced; or alternatively no discount will be applied to either value, in which case the allowable expenditure figure will be correct, but the value for tax purposes of the gift itself will be too high.

The hidden danger is that the taxpayer's accountant may not be privy to the discussions going on between the District Valuer and the taxpayer's valuer, and may not understand how the valuation figures are calculated. He may leave it to them to agree figures which have a discount built into them, and he may then take those figures at face value. If he insists on applying the part disposal formula the Inspector may innocently double the District Valuer's figure for a half share in order to reach the value of the whole.

It is essential that the taxpayer's advisers communicate with each other well enough to prevent this point slipping through the net. The accountant will need to ensure that figures are agreed for (a) the share disposed of (b) the share retained and (c) the value of the whole at 31st March 1982 without any discount. Otherwise the part disposal rules will not be properly complied with, and by the time the taxpayer has disposed of the whole of his asset, 10% of the base value will have been thrown away, plus the indexation allowance attributable to it.

The safeguard is to check with the taxpayer's valuer exactly what the District Valuer has been instructed to value, and follow the agreed figures through carefully in the final computation.