THE NO BOUNTY FORMULA - SUPPLEMENTAL THOUGHTS

Jeremy Heal, Solicitor[1]

In David Tovey's article (2 PTPR 1 (1992/93) 3) it is suggested that the use of a formula for avoiding valuation uncertainties should only rarely be resorted to. One exception given was in order to avoid the tainting of a pre-19th March 1991 non-resident trust. However, there are a number of other situations where a formula is very valuable. It is suggested in this article that the dangers inherent in a formula are often less than the dangers created by potential valuation problems.

Drafting the Formula

Clearly any formula which is used must be properly drafted. Supposing, for example, there is a contract for the sale of shares from an individual to a trust, there must initially be a stated price based on the parties' best estimate of the value. This estimate should clearly be based on the advice of an appropriate professional. The Press Release dated 21st May 1992 refers to "an independent valuer" although it is not clear what "independent" means in this context.

The formula will then need to provide for an adjustment to be made, conditionally upon the happening of a specific event, normally the final determination by the Inland Revenue (whether unilaterally or by agreement), of a value which differs from the stated price. The formula must then provide for what should happen. Will the price be adjusted and an extra payment or repayment be made, or will additional shares be transferred or some shares be transferred back? An adjustment to the price is capable of being made more precisely, but funds must be available on both sides to allow for it if this alternative is chosen. Interest must also be payable in accordance with Mr Tovey's article.

The formula must specify the exact basis of valuation. A valuation for capital gains tax purposes will normally be different from a valuation for inheritance tax purposes or the valuation of a benefit received by a participator from a close company. The draftsman must concentrate on the primary trap he is trying to

1 Jeremy Heal, Partner in Howes Percival, The Guildyard, 51 Colegate, Norwich, Norfolk NR3 1DD
Tel: (0603) 762103 Fax: (0603) 762104/5

avoid, and link his wording closely to the legislation. Indeed, because of the differing bases of valuation it may be inevitable that a transaction which is expressed to be at open market value for capital gains tax purposes will be a chargeable transfer of value for inheritance tax.

Particular Situations

One of the many situations where great care is needed is on a disposal between parties who are closely connected in fact, but are not within the specific definition of "connected persons". The writer has known a situation where a taxpayer sold land to his company's self-administered pension fund, with whose trustees he was not connected. He was anxious to ensure that the values were correct, so that there would be no capital gains tax on his disposal, other than that properly payable on the sale price received from the pension fund, and that he would remain unconnected so that the gain on the disposal could be set off against other losses.

The taxpayer instructed a reputable valuer to assess a fair value. Subsequently the District Valuer was instructed, and disagreed that the sale price represented open market value. He contended that the land had been sold at a modest undervalue to the pension fund.

The taxpayer's advisers argued that the District Valuer's assessment of the open market value was irrelevant, since the parties were not connected persons. The value for capital gains tax purposes should therefore be taken as the actual price. The Revenue argued, disturbingly, that *because* there had been a sale at an undervalue, the sale itself was an "arrangement" under what is now s.681(4) Taxes Act 1988, and therefore the sale amounted to a settlement under which the taxpayer was the settlor. Consequently the parties became connected persons under the provision now re-enacted in s.286 TCGA 1992 and the open market value could be substituted for the sale price. Acting on advice, the tax-payer was (rightly or wrongly) forced to agree rather than fight on both law and valuation, and not only had to pay capital gains tax on money which he had not received, but was unable to set off his losses on other transactions against the deemed gain. It is a dangerous argument and capable of wide application.

Independent Valuers

Lightning can strike twice in the same place. On a subsequent transaction between the same taxpayer and the close company in which he was a participator, two valuers were instructed from different reputable firms, one on behalf of the taxpayer, and the other on behalf of the company. They negotiated a price for a piece of development land on a genuine arm's length basis. The transaction took place at a time of high inflation and close to other development land where, unknown to the valuers, transactions at a very high price were in the early stages of negotiation.

Some four years later the District Valuer rejected the figure reached by the two independent valuers. He substituted a figure which differed by some 30%, citing as a comparable the adjoining land which had changed hands at a price nobody would at that time reasonably have expected. Fortunately, in this particular instance, the taxpayer stood firm and the Revenue withdrew their attack, but not until several thousand pounds' worth of professional fees had been incurred. In this case the risk was of a Schedule E charge on the director in respect of a benefit conferred on him by the company. The value of having two reputable valuers was amply demonstrated, and even this safeguard only just achieved its object.

The Value of a Formula

In both of these cases a formula would have been a useful and valuable safety-net. Both these situations are very common, and there are many other comparable situations where a charge to tax and a "connected" relationship could both be triggered by an incorrect valuation. Furthermore, the delays inherent in the valuation process mean that there is a period of uncertainty which can last for many years after the transaction takes place, and may well have an effect on subsequent transactions.

The formula should provide for the adjustment to be brought into effect only when there is a final determination or agreement as to the value by or with the Inland Revenue. This then gives the taxpayer the option throughout of fighting his corner to prove that the valuations were correct, or giving way and paying (or receiving) the adjustment. To this extent it may speed up rather than delay the conclusion of the transaction, since the taxpayer has a readily quantifiable safety-net.

It must be a matter of opinion whether the incorporation of a formula involves a loss of bargaining power as suggested by Mr Tovey. My personal view is that I have never found this; a formula such as is discussed here has no effect on the actual value, or indeed on the argument. What certainly does matter is the strength of the valuers' convictions that their valuation is correct. I would entirely agree that a single valuer is frequently inadequate, and may be put in an impossible position by being given the job. Two valuers, each acting clearly for separate parties and ensuring that they have their own calculations, comparables and negotiations set out on their files, have infinitely greater authority.

Summary

There are many common situations where an incorrect value placed on a transaction can have several serious interlocking tax consequences. The Inland

Revenue and the District Valuers are not slow to challenge valuations between parties who are not visibly entirely at arm's length. The writer wholeheartedly agrees with Mr Tovey that, for transactions of any size, two independent valuers are essential to give the clients any real element of protection, but suggests that there may be many more situations where a formula can give a welcome measure of comfort by allowing the taxpayer to accept a different valuation without creating a fiscal disaster.