The Personal Tax Planning Review

THE NO BOUNTY FORMULA - A SENSIBLE SAFETY-VALVE?

David Tovey[1]

It is often important in dealings between trustees and connected persons that no bounty should be deemed to have passed as a result of the transaction. A Revenue Press Release issued earlier this year (21st May 1992) suggests a formula for the ascertainment of the consideration under such a deal with a view to ensuring that the Revenue agree that no bounty passes. This, however, may mean accepting the Revenue's own determination of value. Should practitioners utilise this safety-valve?

Sales to Family Settlements

In these difficult days, when many clients' liquidity has vanished and asset values have plummeted, there is the temptation to look to family settlements created in happier times for succour. The idea of an exchange of an illiquid asset, such as a shareholding in a family company or land with long term development potential, for cash or liquid investments sitting in a family settlement is attractive, whether it be to fund Lloyd's losses or to keep at bay the ever-increasing pressures from the bank manager. Trustees who in the past may have dismissed such an idea as not being in the best interests of their beneficiaries may be persuaded that the alternatives, such as bankruptcy of a family member or sale of the family company at a knockdown price to a third party, are even less attractive.

No Bounty

The concern, however, where, say, a father is selling an asset to trustees of a settlement set up by his parents for the benefit of his children, or to a settlement created by another family member, or to a non-resident settlement created before 19th March 1991 and under which his children and/or wife and himself can benefit, is to ensure that no bounty passes to the settlement. It can be very difficult to be absolutely certain that this has been achieved if the assets being sold cannot be valued with any precision.

---

[1] David Tovey, Partner, Wiggin and Co, Solicitors, The Quadrangle, Imperial Square, Cheltenham, Gloucestershire GL50 1YX.
Tel: (0242) 224114 Fax: (0242) 224223

Independent Valuers

The parties can, of course, decide to appoint independent valuers, one acting for the client vendor and one acting for the purchasing trustees but this can prove expensive if the asset involved is a shareholding in a private company. There is also always the temptation to instruct "friendly" valuers, who may in fact not take positions in the "negotiations" that a truly independent valuer would adopt in a sale and purchase between third parties. Nevertheless, even if the two valuers do have detailed negotiations on the value of the asset and eventually agree an appropriate figure, what guarantee is there that such a figure will be agreed by the Share Valuation Division or the District Valuer?

Safety-Valve

If the tax consequences of the valuation being unacceptable to the Revenue are extremely serious (for instance, the client is deemed to be a settlor of the settlement or to have tainted a pre-19th March 1991 non-resident trust), it is tempting to devise a formula in the agreement for sale between the client vendor and the purchasing trustees whereby the consideration stated therein should, in the event of the Revenue determining that an arm's length price was a different figure, be amended to reflect the Revenue's determination. Such a formula, although it may appear attractive initially, is in many cases no easy option and should be avoided wherever possible.

The Revenue's Formula

The debate about whether such a formula should ever be considered has resurfaced as a result of the express reference to such a formula in the Inland Revenue Press Release dated 21st May 1992 on Non-Resident and Dual-Resident trusts. The 1991 Finance Act provided that certain settlements created before 19th March 1991 could become subject to the new taxation to settlor rules contained in such Act if on or after the 19th March 1991 property or income is provided directly or indirectly for the purpose of the settlement otherwise than under a transaction entered into at arm's length (now Taxation of Chargeable Gains Act ("TCGA") 1992 Schedule 5 para 9(3)). Any transaction between trustees of such a settlement and the settlor (or, in fact, any other person) will result in the taxation to settlor rules applying if the Revenue consider that any bounty has accrued to the settlement as the result of the transaction. In the Press Release dated 21st May 1992, the Revenue state in para 13:

> "Solely for the purposes of paragraph 9(3)(a), provision in the document governing the transaction for an appropriate adjustment to the consideration where the value agreed by the Revenue differs from the original consideration arrived at by an independent valuer

> and specified in the sale document is, in general, regarded as falling within the terms of the above definition of an arm's length transaction."

Arm's Length Transaction

This statement is interesting in a number of respects. It is not sufficient for the parties merely to specify in the agreement the lowest consideration that they believe may be justifiable; it is still necessary for the original consideration specified to have been fixed by an independent valuer. Note that the singular is used here.

It is also necessary to show that in all other respects the transaction is at arm's length. In this connection, in the preceding paragraph of the Press Release, the Revenue state:

> "Each case depends on its own facts and circumstances but a transaction is, in general, regarded as being at arm's length where all the facts and circumstances of the transaction are such as might have been expected if the parties to the transaction had been independent persons dealing at arm's length, i.e., dealing with each other in a normal commercial manner unaffected by any special relationship between them."

Use of such a formula is therefore unlikely to result in any cost savings as it is still necessary to demonstrate that the parties have been independently represented. In my view, it would be unwise in the majority of cases to rely on a single valuer acting for both parties.

Is the Revenue Formula of General Application?

A further interesting point arising from the Press Release is that the introductory words of para 13 suggest that the formula will be acceptable "solely" for the purposes of TCGA 1992 Schedule 5 para 9(3)(a). Does this imply that the Revenue do not consider that such a formula works in other instances? Certainly, in the past, doubts have been expressed about the wisdom of using such a formula. How can it be said that a transaction is an arm's length transaction when it contains a formula for fixing the consideration payable that no persons dealing with each other in a normal commercial manner would even contemplate?

Void for Uncertainty?

On occasions, concern has also been expressed that such a formula could be constructed as being void for uncertainty. In my view, there is no inherent reason why such a formula, if properly drafted, need be void for uncertainty but there are certainly instances where there will be no reason for the Revenue to have regard to what would be the proper arm's length price for the transaction, as, for tax purposes, a different set of valuation considerations apply. For instance, if the disposal to the purchasing trustees could be linked to other disposals for the purposes of TCGA 1992 s.19 (deemed consideration in certain cases where assets disposed of in a series of transactions), the Revenue would have no interest in determining the arm's length value of the asset passing to the purchasing trustees. Clearly, the formula should not be utilised in such circumstances.

Time Delay

In other cases, consideration needs to be given to the length of time before the relevant valuation is likely to be scrutinised by the Revenue. For instance, in a transaction between two sets of non-resident trustees, the Revenue may only have cause to consider the price paid under the transaction when a capital payment is made to a beneficiary and such payment may not be made for very many years. If the formula is used in such circumstances, both parties may be uncertain as to the full extent of their assets and liabilities for an unacceptably long period and, in some cases, this may paralyse dealings with the asset purchased or even with the whole trust fund.

Security for Amendment to the Consideration

Before parties agree to any such formula, they also need to give serious consideration to their respective positions in the event of the Revenue determining that the price fixed by the contract is inappropriate. The Revenue make it clear in the Press Release that if the formula is used, then, in addition to the need to provide for an amendment of the consideration, it will also be necessary to provide for compensating interest at a commercial rate to be paid in either direction. For this purpose, it is stated that "the official rate of interest for s.160 ICTA 1988 purposes (beneficial loan arrangements) will usually be regarded as equivalent to a commercial rate of interest, although different rates may be accepted as so equivalent if the circumstances of a particular case warrant this treatment." As from the 6th November of this year, the official rate of interest under s.160 has been 9.75%.

Both parties, therefore, need to be satisfied that if a compensating payment does need to be made, the other party is capable of making such payment, together with compensatory interest. This is the sort of exposure that trustees quite rightly fight

shy of and may only be prepared to accept if they can be suitably indemnified. Who gives the indemnity? How should it be secured? What happens if the person giving the indemnity dies? If the trustees need to call upon the indemnity, will this give rise to the very tax problems that the formula seeks to avoid? These are often questions to which there is no satisfactory solution.

Loss of Bargaining Power

One final point which those involved in dealing with Revenue valuation departments will appreciate: given that valuation questions are often a matter of negotiation, one may be giving the Revenue an overriding advantage by providing in the formula that they have the final decision. What reason would there be for the Revenue to depart from their own opinion as to value?

Summary

There may be circumstances where the uncertainties of valuation are so great and the consequences so dire, e.g., the tainting of a pre-19th March 1991 non-resident trust, that the other disadvantages involved in the use of such a formula are outweighed. In other cases, though, it is suggested that such a formula should only rarely be resorted to. In most situations, it is better to ensure that independent valuers are appointed and that the parties give independent consideration to the transaction. In such circumstances, it would be very difficult for the Revenue to contend that there was any intention to confer bounty upon the trustees. The temptation to reduce cost by cutting corners (e.g., by having the appearance rather than the reality of independent representation) must however be strongly resisted and firm advice given to the vendor client and purchasing trustees in this respect.