A reality check?

Inheritance tax and trusts OMB Personal tax

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David Bowes reviews the FTT decision in the case of *Spring Capital*

Key Points

What is the issue?

Employment contracts and non-competition clauses should be presumed to exist for the valuation of businesses and companies for CGT purposes

What does it mean to me?

This would significantly affect the values of such businesses for tax purposes where, in most cases, they would increase

What can I take away?

The tribunal judge may have erred such that all may not be quite as it seemed

Share and business valuers are an odd crowd, which perhaps explains the frisson of excitement in their ranks when the decision in S*pring Capital Ltd v HMRC* [2015] UKFTT 66 (TC) was announced earlier this year.

Background

Typically, taxpayers establish their business structures in ways that may be commercially advantageous for the operators yet enable HMRC to argue that their value is not captured or maximised in the entity that purportedly exists for tax market value purposes. This may occur when key employees, also the shareholders or proprietors, have transferred a business without also transferring the freehold premises it occupies, or even establishing a formal tenancy over them. This enables HMRC to argue that the ongoing business has no security of tenure over those premises, and accordingly therefore little value. In other cases, it has been argued that the absence of a service agreement between a key employee and the business means that the commercial risk of losing that employee results in damage to the value of the entity.

The long-standing refusal to defer to commercial reality, namely that it is in effect the same person owning and operating the business at all relevant dates, in favour of the strict and perhaps unrealistic position that exists by reason of the market value requirement, which is that no such presumption can be made, has resulted in many unfavourable values for taxpayers. This is particularly so in cases involving transfer of goodwill on incorporation. In *Spring Capital* the issue was the purchase, or otherwise, of goodwill on the transfer of a trade. In the event it was decided that no such purchase had taken place, on the basis of which its value was irrelevant. However, because so much time had been spent in the hearing on the supposed value of that goodwill, the judge was prepared to set out her conclusions on that matter.

The HMRC position

A principal HMRC argument had been that key individuals had no service contracts with the appellant at the relevant date and had not entered into any non-competition agreements.
HMRC’s stance was that, on the premise that the business had to be taken as it stood at the valuation date and that the key employees could therefore depart the business if they wished, the absence of such agreements rendered the goodwill to be of little value. This was argued to be so, notwithstanding that the individuals in question had indicated their willingness to enter into any such contractual arrangements.

This HMRC position was based on the decision in T*he Duke of Buccleuch v IRC* [1967] 1 All ER 129, in essence that:

> ‘...it is not to be supposed, in order to obtain higher figures of valuation, that any substantial expense is to be incurred or work done in organising the estate into units...’ (Lord Reid)

For many years, that was accepted as meaning that, for valuation purposes, the business had to be taken exactly as it was at the date of valuation. If there were no employment contracts, or non-complete clauses, the adverse effect that this might have on value could not be ignored.

The alternative view

However, Lord Reid seemed also to offer a glimmer of hope:

> '...on the other hand, some practical grouping or classification, such as can reasonably be carried out without undue expenditure of time or effort by a prudent man concerned to obtain the most favourable price, may be supposed.'

Lord Justice Hoffman later seized on this in *IRC v Gray (Surviving executor of Lady Fox deceased)* [1994] STC 360, as providing the basis for what he described as the 'reality principle' that:

> '...the hypothetical vendor must be supposed to have taken the course which would get the largest price provided that this does not entail undue expenditure of time and effort...'

The FTT conclusion

In light of these decisions, the judge in *Spring Capital* felt that the taxpayer's expert valuer had been correct in considering that the goodwill in the trade carried on in the particular business comprised:

- the databases, intellectual property and all other information and intangible assets used in the business; and
- the knowledge and expertise of Mr Rod Thomas and Mr Stuart Thomas, two brothers who ran the business.

During the hearing, one of the brothers confirmed that he and his sibling, having worked in the business for many years, would have been prepared to sign employment contracts with a purchaser of the trade and to have entered into any required non-competition covenants. The question for the judge was:

> '...whether on 22 September 2004 the trade should be valued on the basis that a prudent purchaser would heavily discount the value of the business because there were no contracts of employment and no non-competition covenants binding Messrs Thomas into the business or whether it should be valued on the basis that Messrs Thomas would remain with the business and that employment contracts and non-competition covenants would have been entered into. It seems to me that that this method of valuation gives effect to what Hoffman LJ described as the "reality principle" to be derived from *Buccleuch*. In other words, it must be supposed that Messrs Thomas would take the necessary reasonable steps to sell the trade for the highest price. As regards the caveat in *Buccleuch* that this must not entail "undue expenditure of time and effort", it seems to me that entering into employment contracts and non-competition covenants would not have involved undue time and effort, or, indeed, expense. Accordingly, had it been necessary to decide the point, I would have accepted goodwill at £6,390,000 (the taxpayer's value). In my view a valuation of this amount produces a sensible and realistic conclusion. The trade of SSS was producing profits on ordinary activities before taxation of approximately £1 million. It seems counter-intuitive to accept that a business generating these profits would only be valued at £126,000 or nil (the HMRC valuation).'

There is some precedent, albeit limited, for the proposition that regard should indeed be had to such reality. The supposition, based largely on share valuation case law, has long been that the parties to the notional tax sale are hypothetical rather than real, a logic that applies equally for all market valuations, not merely tax ones. The only characteristic the hypothetical vendor is presumed to have is that of owning the asset(s) in question, while the purchaser is assumed to be prudent, that is judicious and careful. In *Walton (Executor of Walton, deceased) v IRC* [1996] STC 68, which concerned the valuation of a partnership interest and a tenancy, it was held first that the open market hypothesis in the relevant legislation did not require that the landlord should be hypothetical; it assumed a sale in the real world. Second, it was a question to be determined by the evidence before the tribunal of fact whether the attributes of the actual landlord would have been taken into account in the market. Accordingly, it was held that the tribunal had not erred in basing its valuation on the personal inclinations and characteristics of the actual landlords rather than those attributable to a hypothetical one. The gravitas gained following *Walton's* progression to the Court of Appeal enabled a precedent to be established.

Spring Capital seems to have built on decisions such as those reached in *Gray*, seemingly supporting at least a defensible case for assuming that contracts, employment agreements, relevant leases or tenancy agreements, could be in place for the purposes of the hypothetical valuation even where as a question of fact they were not. That would undermine the many HMRC arguments that because a business occupying freehold premises had no right of occupancy it also had little or no value. If it could be assumed that key staff would be contractually bound to the business, thus giving it greater security, it too would be likely to have greater value. So far, so good.

But does this change things?

At first glance this appears to be a positive decision for taxpayers. However, it is merely a First-tier Tax Tribunal decision which may not set a precedent. Also, it had been found that, as a question of law, no goodwill had been transferred, so the judge was not required to determine the issue of value. These comments can be interpreted as *obiter dicta*, meaning that they lack legal force.

The immediate question on the notion of assuming as yet unwritten agreements and service contracts or leases to be in place is: what provisions would such documents contain? In some ways all that has happened, if the *Spring Capital* decision holds good, is that we will have moved from one hypothetical position to another. Regard might now have to be had to real persons involved with the business in preference to hypothetical ones. But these real persons would now be treated as having hypothetical employment contracts or leases. It may well be stretching matters too far to endow these hypothetical documents with real terms and conditions, when the severity or complexity of the agreements could also be an issue. In all probability, the value would be a function of those rights and obligations, and vary with the degree of certainty and security that they afford the company. In theory it is possible that the assumption of, for example, the existence of a service agreement tying in a key employee might have the effect of enhancing the value. But the position and more particularly the quantum of any enhancement would remain problematical in the absence of detailed provisions that it would in fact be impossible to determine. What effect on value would the existence of such problematical terms produce? To me, this seems to be a potential minefield as well as being anyone's guess.

Value for CGT not CTT

It came as no surprise to discover recently that Shares and Assets Valuation does not like the decision. Although it may well be for another court to decide whether such dislike is justified, it may be well founded. That case was concerned with a valuation for capital gains tax (CGT) purposes and the implications arising from incorporation of a business. For these valuations, normal tax market value rules apply. Although the legislative wording differs between these taxes, in essence the valuation bases for both inheritance tax (IHT) and CGT are the same, envisaging the value arising on a sale in the open market. CGT focuses on the asset actually being transferred, it being a single asset. In *Marks v HMRC* [2011] UKFTT 221 (TC) for example, in relation to a 31 March 1982 issue for re-basing for CGT, two groups of companies were controlled by the same person and run as one entity. Even though it made little commercial sense to view them separately, the judge felt the position was clear on CGT.

> ‘We conclude that the Appellant had two separate assets at 31 March 1982, which on their deemed disposal on that date are to be valued separately. Capital Gains Tax is computed on the disposal of each asset separately.’

IHT operates differently, as the judge in *Marks* reminds us:

> ‘The cases on death duties under which related assets can be grouped together in order to obtain a better price for both (such as the combination of the deceased’s management shares and voting preference shares so as to give voting control in *Attorney-General of Ceylon v Mackie* [1952] 2 All ER 775) … in our view have no application to capital gains tax … death duties are computed on the value of the estate as a whole, for which one has to split the assets into saleable parcels.’

Unlike CGT, IHT looks at all the assets that are comprised in the transferor’s or the deceased’s estate because the key issue is the value of that estate before any transfer or the deemed transfer on death, with tax being levied on the loss in value occasioned by the transfer of any assets. Therefore, it would be appropriate for valuation purposes for IHT to aggregate natural units, such as voting and non-voting shares in a company, or if small steps could have been put in place to ensure the continuing services of key employees, then that was the logical consequence of applying the estate concept if, on sale, that would be likely to achieve a higher price.

As readers with long memories may recall, capital transfer tax (CTT) enjoyed the same estate concept as IHT; many of the latter’s rules having in fact been developed from that predecessor tax. The decision on which the judge in *Spring Capital* relied, primarily *IRC v Gray*, was concerned with CTT, and the judges in that case would therefore have had regard to that concept when arriving at the values of the shares upon which they were required to adjudicate. Had Spring Capital involved CTT or IHT, the judge might have been correct to find as she did. However, as the case was, as a question of fact, concerned with a single asset for CGT, with no CTT or IHT implications as far as the author is aware, it seems that there might be serious doubts as to whether the judge’s conclusions were entirely accurate.

Contain your excitement, share and business valuers for, although things may not be as they first appeared, neither might the position be as bad as feared. If the FTT decision is ultimately shown to have been correct, this would be a double-edged sword because there will be losers as well as winners. There will undoubtedly be cases where taxpayers would prefer a low value based on the same arguments that HMRC pursued in *Spring Capital*, and who will not be disappointed should that decision eventually fall. Unsurprisingly, it was ever thus.