Valuation Background Paper

Wealth Tax Commission

The valuation of chattels

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THE VALUATION OF CHATTELS

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1. Introduction

It is recognised that the valuation of works of art is not a precise science: it is a matter of skill and judgement. Although a layman might assume that an object can have only one value, experience shows otherwise. A figure put forward for insurance purposes would not necessarily be that given as an auction estimate, for the obvious reason that the first must be a single figure while the second is likely to be a range within which the auction price is expected to fall. Frequently the need for a valuation is for the purpose of agreeing a value for tax purposes with HMRC. Valuations may also be obtained for insurance, sale, family division, chattel rental and other purposes. Sometimes the interest of the owner requesting the valuation will lie in obtaining a high valuation; sometimes in obtaining a low one. Sometimes the owner will not care whether the valuation is high or low.

Professional valuers may only give valuations which are in accordance with their honest opinion as to the value of the item valued. They cannot give a valuation for an item which is different from their true opinion as such a valuation would be false or dishonest and the act of doing so would amount to a criminal fraud leaving both the valuer and owner of the object liable to prosecution. For example, under the Theft Act 1968 the giving of a dishonest valuation could amount to obtaining a pecuniary advantage by deception from another person contrary to section 16 of that Act. The maximum penalty is a prison term of five years.

A valuation is an honest one only if it reflects accurately the true view of the valuer. If it does not tell the truth about what the valuer thinks about the value of the item, then it is a dishonest valuation.

It is well established that there is a range of price, sometimes wide, which competent valuers would recognise as the price which property would fetch if sold on the open market. It is therefore usual for valuers to provide their opinion of the current value of an object by first giving that range of values which is commonly known as current auction estimates; the lowest value of the range being known as the low auction estimate and the highest as the high auction estimate with the median being known as the mid auction estimate. This range usually forms the basis of any other types of valuation of the object. It is then the type of valuation that determines where within that range the value is pitched. They are commonly known as current auction estimates. They give high and low estimates and not a single figure.

They are based on the professional valuer's expertise and knowledge, research into current market trends, values and conditions which then inform their opinion of the amount an item might realise if sold on the open market. This is defined as the price that might be agreed between a willing buyer and willing seller, both having reasonable knowledge of relevant facts and neither being under any compulsion to buy or sell, or the price which the property might reasonably be expected to fetch if sold in the open market at that time [i.e. the relevant valuation date]. They do not take into account commission, sale expenses, taxes or other fees that might be incurred in achieving a sale at auction.

2. Insurance valuations

Auction houses and valuers tend to pitch these at one of three levels which they define as follows:

(1) Insurance at High Auction Estimate

Here the owner would not have in mind replacing the item concerned. In other words this level of valuation envisages that the item valued is regarded merely as an asset for which only financial compensation would be sought in the event of total loss, the value being set simply at the top end of an auction estimate without the addition of the buyer's premium and VAT.

(2) Insurance at double Low Auction Estimate

This relates to those instances where an owner might wish to replace any totally lost item by purchasing something comparable at auction. The insurance value here allows for the possibility of a hammer price just above a High Auction Estimate with the addition of the buyer's premium and VAT.

(3) Insurance at double High Auction Estimate

This relates to those instances where an owner might wish to replace any totally lost item by purchasing something comparable at an appropriate London or New York retail outlet. It is hoped that in general values set at this level are enough to include the usual trade 'mark-up' over auction prices but this is not guaranteed.

An insurance value is a replacement value and hence not relevant when considering the taxation of such objects. Insurance values tend to be much higher than open market values as they also take into account commission and other taxes and fees of a replacement. The amount something will cost to insure will depend on how likely it is to get damaged or stolen, along with how much it would cost the insurer to pay out if it was and cover their costs. If we are talking about a one-off masterpiece by Giotto, say, one would need to go to a high end international picture dealer who in turn will have greater overheads. However, if it is something like a Wedgwood tea set, these are readily available at local antique dealers.

It is customary to revisit insurance valuations every three to five years and if the costs of a detailed physical inspection by a professional valuer are too prohibitive the practice is to update the values by reference to the Art Market Research indices that are like the RPI for art. They are available for a fee on subscription. The Shares and Assets Valuation Team at HMRC has a subscription as does the US Internal Revenue Service (IRS).

Property insured can be covered at an agreed or guaranteed value which is an amount the owner and insurer agree the item is worth and which the owner is guaranteed to receive in the event of a loss. This means that the insured value is agreed before the policy is entered into and in the event of a total loss this is the amount the insured would receive. Although this basis incurs higher premiums it is usually the basis chosen to cover valuable works of art.

Insurance policies often define it as the value agreed by the owner and the insurance company for the purpose of the policy and qualify it as follows: no representation is made by us that those values represent the market value or any other basis of value.

Alternatively it can be at stated or market value, which is a value provided by the insured and not agreed with the insurer. If total loss occurs the underwriter for the insurer will determine the market value for the object at that time and will pay out accordingly which might be less than when they first insured it. So it is ultimately up to the owner on what basis they want to insure their chattel and how much they want to pay in premiums.

A variant of insurance valuations is government underwritten insurance under section 16 of the National Heritage Act 1980 for loans to UK museums. This is called Government Indemnity and is on an agreed value basis. The Guidelines state that the purpose of providing indemnification is that 'the party suffering loss should not be out of pocket as a result of that loss but neither should the loss provide him with an opportunity to profit thereby'.

For Government Indemnity purposes we expect the values, where there is no recent sale history of the item in question, to be pitched at either high auction estimate (i.e. Level 1, which would assume a sale/hammer price at mid-auction estimate and allows for the addition of the buyer's premium plus VAT) or, at most, at double the low auction estimate (i.e. Level 2 above) where replacement of a comparable item at auction is envisaged. This latter is particularly the case where the object lent is owned by Trustees who are required by the terms of their trust to replace objects and therefore owe a duty of care to their beneficiaries to ensure that the objects are covered for such eventuality.

If the item has sold recently then it is the full purchase price that we would anticipate forming the value not an inflation thereof representing e.g. a dealer's hope value or anticipated trade mark-up that can sometimes be three or even four times the premium plus VAT-inclusive auction purchase price. Retail replacement values which commonly include trade mark-ups are not acceptable for Government Indemnity. It is crucial to the survival of the scheme which entails HM Treasury carrying a large contingent liability that values are reasonable and not inflated.

3. Willing buyer/willing seller and valuations for negotiated sales

Values here form a starting point in negotiations for purchase or sale for instance in case of a negotiated sale under the Acceptance in Lieu (AIL) scheme or to a museum. Valuations of this kind are usually pitched at high auction estimate where the valuer is putting forward a value on behalf of the selling owner and at low auction estimate when the valuer is acting for the purchaser, this with a view to a negotiation ensuing.

Sir Jack Baer, the first Chairman of the AIL Panel said that:

> *In advising [ministers and HMRC] on what is an acceptable price for the object, the AIL Panel and its experts have to assess what the object would have fetched at auction on the day that the offer was made. When the taxpayer makes the offer, a justification of the offer valuation has to accompany the letter of offer to the Inland Revenue. Valuation is seldom an easy task, especially for objects of the highest quality where few if any comparable items have passed through the sale room in the previous few years. But if the problems are many, the failures to agree a fair price are few. It may require detailed discussions to reach a value which is acceptable to both offeror and the official side but with patience it is nearly always achieved. The aim is to establish a price that is fair to everyone concerned and which the AIL Panel can justify to Government. I speak from experience in saying that the AIL Panel is <u>not</u> there to negotiate the lowest possible price. Equally it will not recommend a valuation that could only be achieved if two immensely wealthy individuals, determined to get the item at all costs, were willing to bid at auction until one bidder falls exhausted by the wayside.*

4. Valuations for export/customs

The UK export licensing legislation in particular the 2015 Open General Export Licence (OEGL) at paragraph 5(b) states that any reference in this licence to the value of an article shall 'be construed as the value of the article as required to be declared for Customs purposes.' It is reasonable to assume that this refers to how the goods would be valued if it was necessary to enter a customs declaration in the country to which the goods were being exported.

For goods, valuation for customs purposes is calculated according to the (parallel) provisions of the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade (GATT) 1994 ('World Trade Organisation Valuation Agreement') art. 1-7, Regulation (EU) 952/2013 art. 69-76, and in the UK Notice 252.

Customs value is the actual transaction value (article 70 of EU Regulation 952/2013). In the cases where there is no sale at or about the time of import, then the value has to be assessed under article 74 sequentially. This includes provision for the customs value to be:

> *(a) the transaction value of identical goods sold for export to the customs territory of the Union and exported at or about the same time as the goods being valued;*
>
> *(b) the transaction value of similar goods sold for export to the customs territory of the Union and exported at or about the same time as the goods being valued;*

Where there is no sale and no identical goods (with which to calculate a comparable price), but there *is* a sale within 90 days, the customs valuation can be the value at that subsequent sale (according to World Trade Organisation Valuation Agreement art. 6, Regulation (EU) 952/2013 art. 74(2)(c); and UK Notice 252, section 6, method 4).

UK Notice 252 describes the procedure for this situation. In the UK, an importer declares an estimate for customs, pays a deposit and then the difference is made good following the sale. In such cases therefore, the value entered for customs purposes isn't finally determined until after the sale if there is a sale within 90 days.

5. Valuations for taxation

These are usually on death but might also be on other chargeable events. They are usually pitched at the low auction estimates where tax is payable or at high auction estimates if not, e.g. if the spouse exemption applies and the surviving spouse is likely to survive seven years and wants to do a potentially exempt transfer (this with future capital gains tax base values in mind).

For taxation purposes there is a statutory definition: 'The price which the property might reasonably be expected to fetch if sold in the open market at that time [i.e. the relevant valuation date]'.

This is the definition used for Inheritance Tax, Estate Duty, Capital Gains Tax and Income Tax. As Ungoed-Thomas J. stated in his judgement in *Re Hayes' Will Trusts* [1971] 1 WLR 758 which concerned the valuation of property for tax purposes under section 7(5) Finance Act 1894:

> *It has been established time and again in these courts, as it was in our case, that there is a range of price, in some circumstances wide, which competent valuers would recognise as the price which 'property would fetch if sold on the open market'. Neither the section [*7(5) Finance Act 1894] *nor Sankey J.* [in *Earl of Ellesmere v Inland Revenue Commissioners* [1918] 2 KB 735] *requires that the top price of that range should be the price fixed for estate duty. That price together with the lowest price in the range, may be expected to be the least likely price within the range, to be obtained from the open market. The most likely price, in the absence of consultation between the valuer representing conflicting interests, would presumably be the mean price.*

It is generally accepted, therefore, that a fair open market value is the equivalent of a current mid-auction estimate.

He went on to say that:

> *The habitual well-recognised process of arriving at that price is for the executors to put in the lowest price within the range and then to confer with the district valuer who acts to safeguard the revenue. Such has been the accepted process of arriving at the price which the 'property would fetch if sold in the open market' and it seems to me to be as likely as any to arrive at that price within the margin which is the price most likely to be the market price.*

The equivalent definition in the US is Fair Market Value.

6. Conclusion

Open market value is the fairest basis for taxation of works of art and other chattels, not insurance values which are based on the object's replacement value which is the highest amount that would be required to replace a property with another of similar age, quality, origin, appearance, provenance and condition within a reasonable length of time in an appropriate and relevant market and usually include buyer's premium, VAT and other taxes; the level also depends, as stated above, on where the item is replaced: auction is less than retail.

In a taxation context one is not looking to replace the object; rather to tax its continued ownership, so it would be unfair to base that on the object's replacement value which is often much higher than its open market value. It is only fair that a tax valuation is based on the amount your item would sell for on the open market. I would also add that I think it would be fair to allow costs of sale as an allowable deduction – this is permitted for capital gains tax purposes on an actual sale and for estate duty recapture charges on sales of objects carrying an old EDD deferral (*Tyser v Attorney-General* [1938] Ch 426, and Finance Act 1965, s 31(8)).

Although the valuation of works of art is not an exact science there is considerable evidence that the market in art is reasonably well informed: knowledgeable about art-historical considerations and prices. Information about auctions is widely reported. If the classification of a painting is changed the price is almost certain to change because the opinion of experts is the principal determinant of price. Art is not similar to quoted shares, but there is evidence from auction and private sales that can be used to inform a valuation of it. There is also considerable case law and a number of judicial pronouncements on the definition of 'market value':

IRC v Crossman [1937] AC 26; *Re Lynall* 47 TC 375; *Gray v IRC* [1994] STC 360 (CA); *Duke of Buccleuch v IRC* [1967] 1 AC 506 at 525; and *Holt v IRC* [1953] 2 All ER 1489.

In the US the IRS has an Art Advisory Panel of dealers, museum officials, scholars and people from auction houses who advise it about the 'fair market value' of works of art that appear on tax returns. HMRC's Shares and Assets Valuation also has lists of independent experts in the art market or museum world that it can seek advice from on chattels' valuations. Both the IRS and HMRC subscribe to price databases like the Art Sales Index; Artnet; and Invaluable, which record the results of auction sales for flat and decorative arts and other objects. They also subscribe to the Art Market Report, which is like the RPI for art; and the Mei Moses Index, which tracks repeat sales of the same artworks.

In conclusion, I believe the fairest basis of valuing chattels for the purposes of taxation is the statutory open market value basis – namely price which those assets might reasonably be expected to fetch on a sale in the open market (s. 272, Taxation of Chargeable Gains Act (TCGA), 1992; and s. 160, Inheritance Tax Act (IHTA), 1984).

All values can be 'updated' on a desktop basis by use of the Art Market Research indices and other databases of past sales such as ArtNet. The indices are expensive to subscribe to and whilst they are not perfect they are generally accepted as a useful tool, particularly where they can be corroborated by actual market evidence and they are more relevant than, say, the RPI. They can be useful in recording market trends and are one of the tools used by HMRC's Shares and Asset Valuation when risk assessing cases.

Finally I would like to emphasise the importance of continuing the reliefs available for pre-eminent and associated works of art of national importance which has been Government policy since the 19th century. Successive governments have recognised the need for special reliefs if important collections of heritage chattels and other property of heritage interest are not to suffer fragmentation from tax-driven sales especially following a death, this to the disadvantage of the community as a whole. So far as chattels are concerned the reliefs are also perceived as a part of the defence against the outflow from this country of important works of art. The primary aim of the existing legislation and HMRC practice is to enable buildings of historic or architectural interest and the chattels associated with them, land of historic, scenic or scientific interest, and objects and collections of national, artistic, historic or scientific interest to remain in private hands, subject to the owner assuming obligations as to preservation, retention in the UK and the provision of public access (this is currently achieved through conditional exemption from inheritance tax (section 31, IHTA, 1984) and capital gains tax (section 258(2), TCGA 1992).