Valuation Background Paper

Wealth Tax Commission

UK tax valuation and potential wealth tax

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1. Structure and approach to the paper

The purpose of this paper is to seek to answer the question: 'What are the existing principles and approaches in the UK tax code to valuation, which might be relevant to, or inform the design of a Wealth Tax (WT)?' It begins with a review of the UK fiscal valuation landscape, looks at where the difficulties are and why, and considers how the UK tax code seeks to solve these difficulties when presented with them. It tries to answer a range of more specific questions which are subordinate to these large ones: Is there consistency in the valuation approach adopted in the UK code? Where exactly is the complexity and uncertainty? What in particular is the approach taken for Inheritance Tax (IHT), the UK tax which is conceptually most closely comparable to a WT? How does it treat issues such as fragmentation or disaggregation? How does it treat encumbrances on value such as restrictions or debt? What approach does it take to reductions in value post the valuation date? And then, because the fundamental distinction between IHT and any annual WT from a valuation perspective is the frequency of valuation, how are these principles adapted to situations in the existing tax code where valuations are needed more frequently (the Annual Tax on Enveloped Dwellings (ATED) being perhaps the best or most interesting example we have). Finally, it considers some further questions: does the UK tax code in these or any other circumstances ever adopt a formulaic approach to valuation and does it ever exclude asset classes, simply on the basis that they are hard to value?

That we can pose these questions of the existing tax code shows that the valuation questions prompted by a WT are not new problems, never before encountered. Neither are they even hitherto unanswered questions. We should not therefore fall into thinking that in some way a WT raises such fundamental valuation questions that the design of a WT cannot seriously be contemplated. Nor should we fall into thinking that the problems cannot be solved, and indeed in similar circumstances have not to a large extent already been solved, within our existing policy framework. A WT does not require the wholesale drafting of new valuation principles but can incorporate existing ones, modified as considered necessary. The basic concept of taxing capital values is not an alien one in the UK tax code. Nor is the concept of basing annual tax liabilities on a capital valuation. No doubt those who oppose a WT will seek to argue that they are. It is important, therefore, that the discussion is grounded in the fact that the taxation of wealth based on asset values is a recurring theme of the UK tax code. A WT would not be a new departure.

Final decisions on the approach to be taken to valuation issues are not, however, the purpose of this Background Paper, but of the Evidence Paper it feeds into.[1] Equally, the conclusions drawn on other issues such as administration, and tax base will need to be considered in their interactions with valuation. For example, the administrative issues related to valuation fall away reasonably comprehensively if the framework of a WT was to have a high threshold and high rate (along the lines of that proposed by Senator Elisabeth Warren in the US) as opposed to the low threshold and low rate regimes which have historically been more typical in mainland Europe. This is for the simple and straightforward reason that fewer valuations are required as more taxpayers fall below the threshold.

[1] Daly, S. and Loutzenhiser, G. (2020), 'Valuation', *Wealth Tax Commission Evidence Paper*, 9.

2. UK tax valuations: an overview

2.1 Use of net wealth, or asset, valuations in the UK tax code

The core concept for valuations in the UK tax code is that of establishing the 'hypothetical open market value' of the asset in question. In brief, this means the price which would be negotiated between a buyer and seller both of whom are assumed to be anonymous, willing and prudent parties under no compulsion to act. The price is not assumed to be reduced on the grounds that the whole property is to be placed on the market at one and the same time.

This broad principle is adopted comprehensively across the UK tax code and with a great degree of consistency, in IHT[2]; in capital gains tax (CGT)[3] ; for general earnings (IT)[4]; for employment related securities[5] and for ATED[6].

Whilst the majority of the UK tax code charges tax on the basis of transactions, such as the realisation of income or gains, it does contain significant elements where tax is charged on the measure of net wealth or on the value of an asset. The principal UK tax based on net wealth is IHT – the main charge to tax being on the net estate of an individual on death, although the periodic charge regime, applying now to most trusts, is based on ten yearly valuations. In both cases net wealth is quantified at the time of the tax charge on the basis of the open market value principle. We look at the provisions of the IHT code in more detail later.

A different approach is used in two respects for ATED. This is dealt with in more detail in other papers,[7] but is broadly an annual charge on the value of certain residential properties held in a corporate wrapper. In this case, firstly a property is allocated to valuation bands with an annual charge applicable to each band. Secondly, whilst the charge is an annual one, the valuation is not. Instead the property is valued broadly every five years. Thirdly it is based on gross value without any deduction for debt.

The current bands for 2020/21 are:

Property value	Annual Charge
More than £500,000 up to £1 million	£3,700
More than £1 million up to £2 million	£7,500
More than £2 million up to £5 million	£25,200
More than £5 million up to £10 million	£58,850
More than £10 million up to £20 million	£118,050
More than £20 million	£236,250

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[2] Inheritance Tax Act (IHTA), 1984, Section 160
[3] Taxation of Chargeable Gains Act (TCGA), 1992, Section 272
[4] Income Tax (earning and pensions) Act (ITEPA), 2003, Section 62. This is not strictly true in relation to ITEPA where the charge is on the 'money's worth' basis of valuation, the extent to which the asset received can be converted into money by the person receiving it. The *Shares and Asset Valuations Manual* (HMRC, SVM109030) contains a discussion on the difference but says that 'experience has shown that the number of cases where money's worth differs from open market value is small and in general you should proceed on the same basis. The differences therefore are relatively slight apart from in fairly unusual circumstances.
[5] ITEPA, 2003, Section 421
[6] Finance Act (FA) 2013, Section 98(8)
[7] Troup, E., Barnett, J., and Bullock, K. (2020), 'The administration of a wealth tax', *Wealth Tax Commission Evidence Paper*, 11.

There is no annual upgrading or indexation of the valuation between valuation dates, rather it is the annual chargeable amounts which are indexed. The banding approach means that the percentage rate varies within each band and between bands. For example at the bottom of the £10–20 million band, the percentage rate is 1.18%, and at the top 0.59%. The final banding of >£20 million means that there is an effective cap on the tax – but it would be perfectly possible to make it more progressive by adding bands.

There are no reliefs for a fall in market values between valuation dates. Whilst it is perfectly true that if the property is destroyed or burns down or becomes otherwise uninhabitable it comes out of the charge, this is not because the valuation has declined but because it has ceased to be property subject to the charge since it is no longer suitable for a dwelling.

The Pre Owned Asset Tax (POAT) code follows a similar periodic valuation model with valuations for chattels every five years. The charging basis for chattels for POAT is not in any way banded but rather the taxable amount is the official rate of interest × the valuation of the chattel at the valuation date.

Interestingly, the approach does differ for chattels used by beneficiaries of offshore trusts.[8] The deemed taxable benefit is the official rate of interest × the acquisition cost of the asset by the trust or underlying company – which could be many years ago – so the taxable benefit is not based on the current market value of the asset at all. Neither is there provision for revaluation. A similar approach is not taken to land where rental value is used for the benefit and in this respect the treatment of chattels is aligned to the benefit of taking a loan rather than using an asset. It is difficult to discern any persuasive intellectual basis for this approach.

Example of beneficiary charge for chattels used by offshore trusts:

1. [A] is a beneficiary of an offshore trust which owns an art work acquired for £1 million in 2010 which hangs in [A]'s principal private residence. It is currently worth £2.5 million. The official rate of interest is 2.25%. The chargeable benefit is £1 million × 2.25% = £22,500.

2. [B] is a beneficiary of an offshore trust which owns an art work recently acquired for £2.5 million which hangs in [B]'s principal private residence. The chargeable benefit is £2.5 million × 2.25% = £56,250.

As a final example, Council Tax, which is a means of raising local taxation, is based on infrequent valuation. In England and Wales at least, it is still based on 1991 values. It takes a banded approach, with rates being set locally.

The UK tax code therefore contains examples of exact net wealth valuations at the time of charge with tax being charged as a percentage of the valuation (IHT). It also has examples of periodic valuations being applied for an extended period (ATED, POAT, Council Tax) and some with a banded approach (ATED, Council Tax). It is sufficient to note in passing the obvious point that a banded and/or periodic approach is much less onerous where an annual tax is being considered, both in terms of frequency of valuation and of administration. With an annual tax, taxpayer compliance costs and the government costs of administering the tax will be lower for a banded and/or periodic approach, compared to exact valuations at the time of charge with tax being charged as a percentage of that valuation. As we will see, a banded approach also reflects the reality of many valuations: that they are generally within a range rather than an exact number.

[8] TCGA, 1992, Sections 97A–97C

Other parts of the UK tax code which are more transaction based, such as Income Tax, Corporation Tax, and Capital Gains Tax, will use asset valuations less frequently. They are used most commonly in the context of filling what would otherwise be lacunas in the legislation, or preventing opportunities for avoidance, such as those relating to transactions between connected parties. The other main use is in the valuation of a receipt in kind. An example of the former is the assessment of CGT on the value of an asset which is transferred by gift. An example of the latter would be the assessment of income tax on the value of shares issued as employment-related reward, the chattels charge for POAT, or the use by a beneficiary of a trust asset, as we have already seen.

Valuations are also needed where a new tax charge is introduced but where economic gains before the start date are to be excluded from the charge.

On many of these occasions the valuation used for the transaction will provide the base cost for any subsequent disposal, so there is a degree of tax symmetry in the valuation. In this case a low valuation used for such a transaction in calculating the gain or income tax liability respectively will increase the liability on any subsequent disposal.

However, there are an increasing number of CGT valuations required where the acquisition cost is not necessarily treated as the corresponding deemed proceeds for calculating any gain, but is used to exclude economic gains prior to a commencement date. This lack of symmetry will drive high valuations unless there is a need to correlate them with other taxes (such as IHT) where a low valuation might be preferred. Examples would include: (a) March 1982 values used for assets acquired before then; (b) April 2008 valuations for certain assets held in trust where there are non-domiciled beneficiaries who receive capital payments[9]; (c) April 2017 valuations for non-domiciled taxpayers personally owning foreign assets who became deemed domiciled in the UK on 6 April 2017 and who had previously paid the remittance basis charge; [10] (d) April 2015 valuations for disposals of residential UK property by non-UK residents; (e) April 2019 valuations for non-residential UK property and property rich vehicles.

Example of transfer of asset by gift, and of tax symmetry in valuation:

[A] acquired an asset for £100,000 and transfers it to [B], a connected party. The open market value agreed at the time is £150,000. [B] sells the asset two years later for £210,000.

The taxable gain on [A] on the disposal is £50,000 (£150,000 - £100,000) and on [B] on disposal £60,000 (£210,000 - £150,000). Any difference in the value agreed for the connected party transaction will, in this type of case, simply alter the distribution and timing of the tax liability between A and B rather than the sum ultimately taxable.[11]

Example of valuation without tax symmetry:

[A] becomes deemed domiciled in the UK with effect from 6 April 2017 owning a significant overseas property. This was acquired in 2009 for £10 million. Due to asset growth inflation it is valued at £28 million at 6 April 2017. Due to the effect of COVID-19 on commercial property, it is sold for £20.2 million in 2022. [A] has a tax loss of £7.8 million on sale. The economic gain of £10.2 million is untaxed even if remitted.

[9] FA, 2008, para 126
[10] FA (No 2), 2017, Schedule 8 Part 3: Capital Gains Tax rebasing
[11] This assumes that [B] remains subject to CGT on the disposal of course.

A final point is that whilst, as we have noted, the open market value concept is incorporated in various ways into the tax code – whether by way of exact valuations at the time of the tax charge, periodic valuations, or the use of a banded system – the principle remains that each asset is valued, when valuation is determined, on the basis of the price which the property might reasonably be expected to fetch if sold in the open market at that time. Whilst the valuation might be periodic in some cases, and whilst the tax liability that valuation produces may be banded, the valuation principle undergirding the liability remains the open market value of that particular asset at the valuation date.

The legislation nowhere (except arguably in the very narrow provision for chattels as a trust benefit)[12] inclines toward the compromise of this principle in relation to hard-to-value assets. Such approaches have been common in non-UK jurisdictions where hard-to-value assets, such as private company shares, are valued on the basis of book value or a formulaic approach is taken. This finds no real echo in the UK tax code. Where simplicity is needed, the consistent approach taken has not been to compromise the open market value benchmark, but rather to look at its frequency of application or in some cases to apply a banded approach reducing the need for precision.

2.2 The tax valuation is often a range of values rather than a single 'correct' value

We have seen that in concept, tax valuation is simple in that it seeks to establish a 'hypothetical open market value' of the asset in question and that this means the price which would be negotiated between a buyer and seller both of whom are assumed to be anonymous, willing and prudent parties under no compulsion to act. The 'correct' value is therefore the price that would be mutually acceptable to both buyer and seller in this hypothetical open market.

Whilst the concept is simple, the scale of case law which it has given rise to is an indication of a range of complex and contentious questions which can arise in the world of hypothetical, rather than real, transactions. Pretend scenarios will after all diverge from reality not least because, from the owner's perspective, actual liquidity is rather different from hypothetical liquidity. The full range of situations cannot be captured within the legislative provisions and as a result the disputed valuation range can be very wide, not least because of the subjectivity of the assumptions which are necessarily used in any valuation. Unless there is an active market in the asset, such as those for quoted securities or options, even between skilled professional valuers, the value of an individual asset will be within an acceptable valuation range rather than there being a single 'correct' answer. If we look at fine art as an example of a hard-to-value asset, fine art sold at auction will often be sold at prices significantly beyond the indicative or expected price. Less frequently, at least in the last several years of a bull market in fine art, pieces will fail to make their indicative or expected price. The indicative or expected price in these cases is effectively a hypothetical one. The agreed price is the actual market value.

For hard-to-value assets the best that can be arrived at is the likelihood that the value of an asset is within a range of values. This of course gives an intellectual legitimacy to the idea of a banded tax.

[12] TCGA, 1992, Section 97B

2.3 The costs of valuation as a proportion of tax yield potentially increase for an annual WT

If we take the existing UK IHT code as the closest we have to a WT, using this open market value valuation framework for the purposes of a WT has the advantage that it uses rules taxpayers have been working with for many years already. The problematic issue is that the IHT rules are (with the broad exceptions of the ten year charge, exit charges and entry charges relating to trusts) applied only once in a generation on the death of an individual and with a 40% tax rate. If an annual WT is charged at much lower rates the valuation costs as a percentage of the tax collected would be much more significant. This point would not, it goes without saying, apply to a 'one-off' rather than annual WT.

We can perhaps note here, almost in parenthesis and for completeness, that the IHT methodology is slightly complicated by the fact that although the same general principles are adopted for most taxes in determining how property is to be valued, the approach differs in determining what property is to be valued for a given tax. For the purposes of CGT for instance, what will normally fall to be valued would be the property disposed of. For the purposes of ATED what will fall to be valued is the property itself. This is also the case for IHT on death or the ten year charge regime. Where, on the other hand, there is a lifetime gift for IHT purposes, the property disposed of will in theory not be valued at all since the measure of the taxable amount on a transfer is the reduction in value of the estate. So if [X] owns 60% of the shares in [X] Limited and he makes a transfer of one-quarter of his shares, he is not treated as disposing of the value of 15% for IHT purposes but on the difference between the 60% and 45% holding. Hence favourable valuations for CGT purposes by transferring shares in blocks of less than 10% are not easy to achieve for IHT purposes.

It follows that this 'loss in value to the estate' principle for IHT needs two valuations, the 'before' valuation and the 'after' valuation. However the loss to the estate principle would not in any way be relevant for a WT and therefore the WT would be based on the single valuations used in CGT, ATED, IHT on death and other UK taxes.

Finally, we can note in passing that whilst discussion of this point is not the subject of this paper, the costs of valuation to both taxpayers as a class, and the tax authority, are minimised with a high threshold/high rate WT as was proposed by Senator Warren and Senator Saunders in the US, as opposed to the lower threshold/lower rate models more typical of some mainland European wealth taxes such as Switzerland and Norway. This is simply because the tax in this case applies to fewer taxpayers.

3. What makes tax valuation complex or uncertain?

3.1 Nature of asset class

Whilst the open market benchmark applies across all asset classes, the ease of application varies depending on asset class. There are financial assets for which there is an accepted and easy method of valuation because they are frequently traded. These will include listed securities, quoted options or derivative contracts. Direct Contribution pensions will be in the same category. Direct Benefit pensions also will have transfer values.

For some classes of non-financial assets such as real estate, we can still approach a reasonably reliable and straightforward assessment of market value by making a comparison with the value of similar assets in the market. Estate agents' prices for land and buildings will provide a guide. Other classes such as art or antiques are more difficult as each is likely to be an exceptional asset which is unique and for which there is no directly comparable benchmark. Auction prices achieved for art and antiques, and in some cases insurance values, may provide a guide.

Shares in private companies – especially where there are impending transactions, the shares are a minority interest, or the shares have tailored rights – or shares in high-tech or other intellectual property rich start-ups will equally be in the hard-to-value category. Non corporate business valuations or valuations of intellectual property rights will also reflect these difficulties.

3.2 Commercial and fiscal valuation divergence

The benchmark for tax valuation is a hypothetical open market value which suggests a close alignment between commercial and fiscal valuation principles. But in fact, as fiscal valuation case law has grown, so has the divergence between the conventions applying to those valuations and the approach applied to commercial ones. As a result those who undertake fiscal valuations would often not be involved in commercial valuations of companies, and vice versa, because the approaches which attach to the hypothetical world (rather than the real one) diverge rather significantly.

The dynamic of each situation is entirely different. A commercial valuation will generally be forward looking, based on seeking to assess the current value of future economic outcomes; will normally have access to more data on these outcomes; will be more influenced by quoted comparables; will often be looking at the extent to which combined entities can realise value in their combination; and generally will be with a view to maximising value on an actual or putative transaction. Fiscal valuations will tend to be rather more backward looking, more conservative and will often be assumed to have much less data available. There is inevitably a slightly formulaic approach to them since they are not undertaken with a view to a real world sale. The transaction assumed in a fiscal valuation is after all only hypothetical and that is rather different to an actual transaction. Trailing price-to-earnings ratios in a commercial valuation can reach the 100's particularly at times of market exuberance. A trailing price-to-earnings ratio in a fiscal valuation would only rarely be in the teens.

3.3 Valuations for tax create inherent bias

The final obvious comment to make is that fiscal valuations are made with a tax liability in mind and that will create inherent bias. Given that there is often no single correct valuation it is perhaps most commonly the case that a valuation towards the low end of a range would be preferred. This would usually be the case for IHT valuations, ATED, and connected party transfer CGT valuations. In the case of an IHT valuation on death, for example where the asset is non-exempt, there is an arbitrage between saving tax at 40% on the estate and increasing tax on a subsequent CGT disposal at 20%. This drives towards a low range valuation. (The alignment of CGT rates with IT rates, if it ever occurred, would incidentally reduce the tax arbitrage opportunities attaching to valuation.)

However, this is not always the case. We have seen in the case of valuations without tax symmetry that a high value is beneficial. Equally, for IHT, where assets are non-chargeable on the death of the taxpayer (e.g. due to spouse exemption) but the acquisition cost for the transferee needs to be determined for CGT, a high value will be preferable.

In the case of a WT it is likely that valuation would tilt towards the lower ends of the range. However, the effect of this could be minimised if valuations for other tax or commercial purposes were to be correlated with any WT valuations.

4. Some existing statutory and case law valuation principles especially applicable to IHT

4.1 Statutory provisions: open market value

We have already seen that the core statutory valuation provision for IHT is 'open market value:[13]

...the value at any time of any property shall for the purposes of this Act be the price which the property might reasonably be expected to fetch if sold in the open market at that time; but that price shall not be assumed to be reduced on the ground that the whole property is to be placed on the market at one and the same time. IHTA 1984, Section 160

The same open market value principle is applied to CGT, ATED, and in the Income Tax (Earnings and Pensions) Act.

However IHT is the only UK benchmark tax for valuing total net wealth and has therefore anticipated some of the issues likely to be relevant in the design of a WT. It is worth mentioning in passing that there are some particular rules attaching to IHT on death which would not be relevant to a WT. The valuation for IHT on death is carried out as if the taxpayer immediately before his death had made a transfer of value. However, some changes in the value of the estate which have occurred by reason of death – e.g. proceeds of an insurance policy maturing on the deceased's death – are included in the valuation of the estate.

Whilst this is noted, it is not particularly relevant to a WT.

4.2 Some important valuation concepts for IHT which need to be considered for a WT

The first group of issues to look at addresses the ways in which valuations might be reduced through either asset fragmentation or by attaching obligations of some sort to the property in question. Within this category will be the idea of valuing assets together, the concept of related property, the approach to valuation restrictions, and finally the approach to liabilities. All of these will be very relevant to a WT.

This is also the place to consider and reflect on the approach taken to the fall in value of assets in the context of IHT liabilities since the question naturally arises in the context of any WT.

Valuing assets together or separately

The rule here is simply stated. As a generalisation or default, valuations are carried out on different items in an estate separately. However items should be valued together if they are worth more together than separately. This is intuitively an obvious approach to take. If a collection of assets held by the same person are worth more as a complete set than separately, then of course it follows that the valuation should be of the set.

[13] See *Inheritance Tax Manual* (HMRC), IHTM09703.

Slightly less obviously, this can apply even if property is held in separate titles. The typical situation is where property is held in the estate of an individual on death, with them also having a life interest under the will of a deceased former spouse.

The authority for this is in case law.[14] The further principle that assets are divided or combined in the lots which achieve the best price is simply an application of this line of thinking.

So this rule removes any approach to achieving a reduction of value through the fragmentation or the disaggregation of assets held within the individual's estate or failing to be treated as part of the individual's estate. If we were simply stop here however, there would still be the opportunity to fragment by making gifts to connected persons.

The concept of related property and the related property rule

The related property rule therefore extends this principle of aggregation to property held by related parties. Whilst related parties can include charities or other bodies to which exempt transfers can be made by an individual, the most common related party is the spouse or civil partner. The rules aggregate the values of assets held (for example by spouses) with an appropriate proportion of the value then being taken into account for each individual.[15] Again, at the risk of labouring the point, this is necessary to counter the potential for splitting ownership to reduce asset values and for exactly the same reasons a similar rule would be needed for any WT. Any consideration of a WT would need to consider whether the definition of related property should be extended to prevent fragmentation strategies which are currently available within the IHT code such as transfer to children whether absolutely or within a trust or other wrapper.

Example of related property valuation:

Jim owns 35 shares in [X] Limited, which has an issued share capital of 100 shares. His wife, Janet, owns 30 shares in the same company. In the absence of the related property provisions both shareholdings would be valued on a minority basis, so let us say that a 35% holding might be worth £300,000. Under section 161(2) IHTA the property comprised in Jim's estate is related to the property comprised in Janet's estate and vice versa, being an aggregate 65% shareholding. Since a 65% shareholding carries control, it is worth £1.7 million. Jim's holding is valued as his proportionate share of the £1.7 million – being £915,000 – rather than the minority basis valuation of £300,000.

There is incidentally no similar rule in any other part of the UK tax code.

Valuation restrictions on the freedom to dispose of assets

If these first two rules are directed at preventing reduction in value by fragmentation or disaggregation of interests, the next two are directed at preventing reduction in value through encumbering an asset with obligations which might otherwise reduce its value.

Looking first at restrictions on the freedom to dispose of assets, the IHT legislation includes a specific statutory provision that where the right to dispose of an asset has been restricted or excluded by a contract then unless consideration is given for the right, the restriction is ignored.[16] This is essential to avoid the situation where a restriction on transfer is claimed to

[14] *Att-Gen of Ceylon v Mackie* [1952] 2 All ER775. *Gray v IRC* [1994] STC 360
[15] *Inheritance Tax Manual* (HMRC), IHTM09712
[16] IHTA, 1984, Section 163

reduce or eliminate the value of the asset.[17] This concept is applied by case law for CGT and income tax.

If consideration was given in part, the effect of the restriction is taken into account proportionately to that consideration given. The example below will show how this principle is applied in the most obvious circumstance of the grant of an option at an undervalue. Whilst the example is focussed on the effect on the value of the asset itself, the grant of the option at an undervalue may of course also be taxable.

An example of ignoring, or partly ignoring, valuation restrictions:

[A] grants [B] an option to acquire property on [A]'s death for £1 million. [B] pays £100,000 for the option when the market value of the option was £200,000. [A] dies and the property is worth £1.5 million but only £1 million subject to the option agreement.

Partial consideration was given for the option so a proportion of the reduction in value attributed to it is recognised:

£100,000 ÷ £200,000 × £1.5 million - £1 million = £250,000.

The value of the property on death is therefore £1.25 million.

However, if, as is likely to be the case, the grant of the original option at undervalue was taxable at the time, or becomes taxable as a potentially exempt transfer at the time of death, the value of the property at death is reduced by the chargeable amount: in this case by a further £100,000. In this event, the value of the property becomes £1.25 million - £100,000 = £1.15 million.

Had full consideration been paid for the option, the value of the property on death would have been £1 million. Had no consideration been given, the value of the property on death would have been £1.5 million less any credit arising from the taxation of the original grant of the option.

Whilst this allowance for any chargeable transfer occurring on the original grant is intended to remove the economic double taxation which would arise if the taxpayer was both taxed on the grant of the option, only to have it ignored for the purposes of the subsequent chargeable event, it does not entirely achieve this.

Restricting the deduction of liabilities

As a general rule, liabilities which are an encumbrance on a property are taken to reduce the value of the property. However, there are restrictions on deductibility where debt is used as a means of artificially reducing value by exploiting mismatches in the tax base for IHT. For example a non-UK domiciled individual[18] is subject to IHT only on UK situated assets but not on non-UK situated assets. The individual could, in these circumstances, borrow against a UK asset and deposit the proceeds offshore removing the UK estate from liability. Alternatively, those involved in a business could devalue their non-business properties by borrowing against them to fund the business, sheltering the proceeds from IHT through Business Property Relief. Finally, loans can be made to taxpayers with rolled up interest which are a charge against an

[17] *AG v Jameson* [1904] 2 IR 644

[18] See Chamberlain, E. (2020), 'Defining the tax base – design issues', *Wealth Tax Commission Evidence Paper*, 8, Appendix B.

estate, but without any real intention they should be repaid. All of these avoidance opportunities have been tackled, although on something of a piecemeal basis.[19]

The anti-avoidance provisions introduced in 2013 have had the effect of only permitting the deduction of debt from the value of the property, in the case of foreign domiciliaries, if the debt was taken out to purchase or improve the property. Equally there are similar restrictions to prevent the devaluation of non-business property when the loan is taken out for business purposes. Finally, loans are not deductible on death for IHT purposes unless they are repaid or it can be shown that there are good commercial reasons why they should not be repaid.

Losses subsequent to the valuation date

What about relief for losses? There are broadly three IHT reliefs in relation to reductions in value post the valuation date which apply only to transfers on death. The first is that relief is available where related property or other property in the deceased's estate under a different title is sold within three years at a loss.[20] This, in very general terms and where all the conditions for the relief are satisfied, partly undoes the valuation aggregation which takes place under the application of these two rules. The second is where quoted shares and securities are sold at a loss within 12 months of death.[21] The third, where land is sold at a loss within three years of death.[22]

Whilst the legislation is framed as applying to sales rather than reductions in value, in practice, in the case of quoted shares and securities, there would routinely be a review of portfolios approaching the 12 month point and losses would be realised where there has been a significant reduction in value.

Whilst it is easy to see that such reliefs are appropriate perhaps for a once in a generation tax it is less easy to see that they should be incorporated in an annual tax even if the valuations are infrequent.

4.3 The related issue of 100% relief for an asset class, or asset class exemptions for IHT

The issue of 100% relief for an asset class or asset class exemptions should not be ignored in the context of a discussion on the valuation approach to IHT and therefore the approach which might be taken to the design of a WT. Whilst such reliefs cannot be said to be an approach to valuation, they at least would have the effect for an annual WT of dispensing with the need for a valuation. Whilst this is not the place for a lengthy discussion on the subject, the most commonly accessed reliefs will be those provided by the codes respectively for Business Property Relief (BPR)[23] and Agricultural Property Relief (APR).[24]

Amongst other things these provide 100% relief for IHT for a range of hard-to-value assets including a business or interest in a business and unquoted shares, so long as the business or the business carried on by the company is broadly not an investment one.[25]

[19] IHTA, 1984, sections 162A, B and C and Section 175A
[20] IHTA, 1984, Section 176
[21] IHTA, 1984, Section 179
[22] IHTA, 1984, Section 191
[23] IHTA, 1984, Sections 103–114
[24] IHTA, 1984, Sections 115–124
[25] IHTA, 1984 Sections 105 (1) (a), (bb) and (3)

However, it seems reasonably clear that the policy behind such reliefs is one designed to protect such businesses from the impact of IHT on an unpredictable event (death) and to ensure that they do not need to be sold in whole or in part to fund the tax liability of owners. They are not driven by the issue of difficulty of valuation.[26]

Whether and to what extent such approaches should be incorporated into any WT will be the subject of other papers. Clearly, whilst it is at least one approach to reducing the burden of valuing hard-to-value assets, any such approach creates horizontal inequity between taxpayers holding different asset classes.

4.4 Case law principles

The key underlying assumptions or conventions established by case law in relation to valuation are that:

(1) the sale is a hypothetical sale;
(2) the vendor is a hypothetical, prudent and willing party to the transaction (they do not assume the characteristics of the actual owner of the property);
(3) the buyer is a hypothetical, prudent and willing party to the transaction;
(4) the vendor and buyer are anonymous parties so have no personal reasons to transact;
(5) the vendor and buyer are under no compulsion to transact;
(6) for the purposes of the hypothetical sale, the vendor would divide the property to be valued into whatever natural lots would achieve the best overall price;
(7) all preliminary arrangements necessary for the sale to take place have been carried out prior to the valuation date;
(8) the property is offered for sale on the open market by whichever method of sale will achieve the best price;
(9) there is adequate publicity or advertisement before the sale takes place so that it is brought to the attention of all likely purchasers;
(10) the evidence that informs the valuation is what would have been available at the valuation date;[27]
(11) conventions for the information that is available to the buyer which in the case of unquoted shares or securities has a statutory basis in the 'Information Standard' discussed below;
(12) actual transactions involving the sale of the asset should be taken as offering some benchmark to value although this may not be conclusive;
(13) the valuation should reflect the bid of any 'special purchaser' in the market (provided they are willing and able to purchase);
(14) the costs of sale do not reduce the open market value.

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[26] This is not to say that the scheme of business property relief is wholly coherent. The reason for 100% relief for Alternative Investment Market (AIM) shares is hard to discern because liquidity is available.

[27] Hindsight cannot be used in a valuation, but there are situations where later data can be used to verify the accuracy or reliability of the assumptions used. Using subsequent data to verify assumptions used is an increasing trend in the context of income tax valuations of 'hurdle' or 'growth' shares where the valuation relies on an assessment of future returns on the investment and professional valuers have tended to ascribe very low values to such securities. Non-standard share structures (growth shares, hurdle shares, shares with voting control but no economic rights, etc.) receive very little attention in current HMRC guidance, so valuation principles remain murky.

4.5 The 'Information Standard'

In the context of the valuation of unquoted shares and securities, the IHT legislation specifies what information is deemed to be available to the buyer (the Information Standard):

In determining the price which unquoted shares or securities might reasonably be expected to fetch if sold in the open market, it shall be assumed that in that market there is available to any prospective purchaser of the shares or securities all the information which a prudent prospective purchaser might reasonably require if he were proposing to purchase them from a willing vendor by private treaty and at arm's length. IHTA 1984, Section 168

Similar provisions are applied for CGT and income tax purposes by section 273(3) Taxation of Chargeable Gains Act (TCGT) 1992.

HMRC's interpretation of what a buyer might reasonably require results in different amounts of information being deemed to be available to different purchasers. Ordinarily, confidential information would not be treated as available where the buyer was acquiring a minority interest. By its nature confidential information is likely to be price sensitive. However, where the monetary value of the purchase is significant, the buyer is treated as being entitled to more comprehensive information. This extends to price-sensitive information, such as regarding a potential sale of the company or future cash flows.

In practice, the Information Standard results in different prices being attributed to shares in the same company on the same valuation date where one shareholding was larger than another[28] which accentuates the divergence in value between an unquoted minority interest and a controlling one.

Simple example of Information Standard effect:
An unquoted life sciences company is very close to receiving regulatory approval for a new medical treatment following successful trials. If the regulatory approval is unsuccessful then the company might be worth £2 million. If successful, the company might be worth £100 million. The valuation of a minority interest will be based on the £2 million. A valuation of a majority interest will be much more closely aligned to the £100 million.

For most valuations, information which is personal to an individual is ignored on the basis that buyer and seller are assumed to be anonymous parties with no special reason to transact. Where an individual was aware of information in their personal capacity but which was not otherwise publicly known (such as an impending offer for the company or plans for a flotation), this would to the seller typically increase the value of their shares as they would require a higher price to consider selling them or to the purchaser increase the price they would be prepared to pay as they can expect to obtain a better price in any subsequent transaction than they are paying for them. Although it is easy to envisage situations where private information could significantly affect share values (being the reason for insider trading rules) HMRC's guidance downplays the difference.[29]

The Information Standard is one of the reasons why a deferred cash flow based valuation methodology is very rarely used for tax purposes, since a buyer would not have access to the detailed financial forecasts required unless they were buying a controlling interest. However, in

[28] *Couch (Inspector of Taxes) v Caton's Administrators* [1996] STC 201; *Clark (Executors of Dorothy Anne Clark deceased v Green* (HMIT) [1995] STC 99.
[29] *Employment Related Securities Manual* (HMRC), ERSM20400.

some market sectors, such as drug development, a discounted cash flow valuation model will be the only reasonable means of assessing share values.

4.6 Some concluding comments on the existing IHT valuation framework

It is perfectly easy to critique the existing framework for valuation within the IHT code. However the criticism would in the end be based not on the approach taken by the tax code, but simply based on the fact that valuation is complex and is not a formulaic exercise.

It is likely, for a whole range of reasons, that hard-to-value assets will, under the existing rules, be attributed lower values than their economic values, and easy to value assets will be closer to their economic values. Valuations for works of art or for unquoted shareholdings would probably be at the lower end of their economic range. Portfolios of quoted securities or financial assets will much more precisely reflect economic value. This creates a degree of horizontal inequity between taxpayers. However the inequity is much less than would be the case if, for example, unquoted shareholdings were valued at book. At least under the current framework an attempt is being made to approximate to economic value.

The principal challenge is not in the existing valuation approach, which is fit for purpose, but in how to accommodate the complexity of the valuation approach to an annual WT. We have seen in the previous discussion how the UK tax code accommodates this under the ATED, POAT and Council Tax frameworks by a combination of less frequent valuation and a banded approach which could easily be imported into the WT.

5. A few conclusions

Let’s now draw together the threads of the discussion to set out what seem to be some foundational or guiding principles in the approach taken to valuation in the existing UK tax code, summarising our answer to the question: ‘How does the UK tax code deal in principle with the valuation challenges that recur in the design of a WT?’:

(1) Firstly, the open market value principle is consistently applied throughout the tax code whether for infrequent occasions of tax (IHT); more frequent (but in the context of an individual taxpayer, less regular) occasions (IT, CGT); or on recurring annual occasions of tax (ATED, POAT).

(2) When the open market value principle is subjected to the pressure of increased frequency of valuation to create an annual tax charge, the approach is not to adopt a simplified, formulaic or proxy approach to valuation such as using book value for private company shares. Instead the tax code preserves the open market value principle but carries out less frequent valuations making them serve for multiple occasions of tax over a more extended period (ATED and POAT).

(3) The only time when this principle appears to be breached is in the benefits charge for the use of chattels held by a trust and a moment’s reflection shows how unsatisfactory this is from both an intellectual perspective and from the perspective of fairness between taxpayers.

(4) When a periodic valuation is used for a series of annual tax charges, as in the case of ATED, there is no indexation or other formulaic adjustment to the valuation in the intervening period. Rather, in the case of ATED, it is the charge which is indexed.

(5) The UK tax code also has aligned itself in places to the fact that hypothetical open market value is realistically within a range of values rather than an absolute correct single value by adopting a banded valuation approach (ATED and Council Tax).

(6) There are asset class exemptions or reliefs in the IHT code, but these seem to be driven broadly by policy objectives of relieving these asset classes from the tax rather than being in any way influenced by the desire to simplify the task of valuation.

(7) There are limited reliefs for losses or reductions in value from the ‘snapshot’ open market value for IHT where the charge is on death. There are none in the case of ATED where the valuation serves for a series of annual charges. Whilst arguably this particular feature of ATED could create inequity if there was a fall in value between valuation dates, this is mitigated by the fact that ATED is banded and effectively capped. As a result, in many cases a reduction in value would not alter the band and therefore the tax liability.

(8) The IHT code has a series of valuation provisions to protect the tax base against erosion through fragmentation or the reduction of value through placing restrictions on an asset or loading it with debt. These issues will need to be addressed in relation to a WT.

(9) Finally, if for some reason a ‘one off’ WT was to be considered, the IHT code in relation to valuations would serve for this purpose pretty much in its entirety.

As we have previously noted, the issues presented by valuation for a WT are far from being new. Rather they have been the subject of long reflection as the UK tax code has evolved, with the intellectual approaches taken to them in principle being pretty well established. This does not mean that we cannot think about entirely new approaches to the issue if we want to. It does however mean that there is no imperative to do so, if we wish to ensure that drafting and introduction is as simple as possible.

What we can say from a review of the valuation provisions in the UK tax code is that they together provide a perfectly sufficient range of solutions to apply to the design of a WT which would be relatively easy to execute and administer. A high threshold/periodic valuation/banded WT for example, presents no particular design challenge. We should not therefore imagine that valuation issues present any insurmountable barrier, or indeed any barrier at all, to the design and introduction of a WT in the UK.