

# Share and share alike

*A recent case clarifies various issues relating to the valuation on death of shares and other securities, as Philip Simpson explains*



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**'The fact that statute requires a hypothetical sale does not render irrelevant evidence that in the real world no buyer would have purchased the asset as it stood. It is clearly a factor that points to a large discount on the value being appropriate.'**

The case of *Executors of MacArthur (dec'd) v HMRCC* [2008] concerned the existence and valuation of options to convert into ordinary shares certain loans made by the deceased to close companies in which he had been a shareholder. There were issues as to whether the conversion rights were sufficiently proved, doubts about whether they still existed, and questions about the appropriate discounts for majority and minority shareholdings. The valuation was undertaken pursuant to s160 of the Inheritance Tax Act 1984:

Except as otherwise provided by this Act, 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.

In short, the Special Commissioner (Gordon Reid QC) held that the options existed at the date of death, and should be valued in effect as if the loans had been converted into shares in the companies. The reason for the latter part of the decision was that this is what a hypothetical purchaser would have paid for them immediately before Mr MacArthur's death. The 'as if converted' basis meant that certain minority shareholdings became majority ones. The case raises interesting questions about valuation of shares, the importance of the background law, and the objectivity of expert witnesses.

## **Background**

When he died on 14 July 1994, Ian MacArthur's estate included ordinary

shares in three close companies: Cape Wrath Hotel Company Ltd, Chapman of Inverness Ltd, and New Inverness Laundry Company Ltd. Both Cape Wrath and Chapman owned shares in New Inverness. All three were investment companies by the time Mr MacArthur died. They had previously sold their trading businesses, and their assets were mainly quoted shares (Cape Wrath still owned the hotel but rented it out to a hotel operator).

The experts both agreed that the nature of the companies' activities made it appropriate to value their shares on an assets basis. As a whole, Cape Wrath was worth £542,226 plus the value of shares it held in New Inverness (see below). Chapman was worth £744,994, again excluding shares it held in New Inverness. As a whole, New Inverness was worth £473,063. This was after deduction of £9,370 of loans due by it but which were, it was held, convertible into ordinary shares. It was agreed that conversion would increase the value of New Inverness by £1 for each £1 of loan converted.

The three companies were family companies. Mr MacArthur, although not having majority shareholdings, had day-to-day control of them.

It is necessary to give some detail of the shareholdings in the three companies.

Mr MacArthur owned 670 of the 2,500 issued ordinary shares in Cape Wrath (a minority shareholding of 26.8%). Cape Wrath's assets included 1,050 of the existing 3,500 issued ordinary shares in New Inverness. But Mr MacArthur owned 991 of those ordinary shares, and (it was ultimately held) options to convert loans of £8,000, in aggregate, into additional ordinary shares at par. Other shareholders in New Inverness had options to convert

a further £1,370 of loans into ordinary share capital. Thus, if all the loans were converted, New Inverness's issued share capital would increase to 12,870 (although New Inverness's authorised share capital was insufficient to cover this). Mr MacArthur's shareholding would increase from 28.3% to 69.8%. By contrast, Cape Wrath's shareholding in New Inverness would decrease from 30% to 8.15%. The value of Cape Wrath would be reduced (as its shareholding in New Inverness was one of its main assets), but the value of Mr MacArthur's interest in New Inverness would increase dramatically.

In addition, Mr MacArthur owned 2,375 of the 8,000 issued ordinary shares in Chapman, and therefore a 29.7% holding. But he also (it was held) had an option to convert a loan to Chapman of £3,500 into ordinary shares. If this were converted into shares, Mr MacArthur's shareholding would have been of 51.1% of the company, being 5,875 out of 11,500 ordinary shares. Chapman also owned 400 shares (11.4%) in New Inverness, but no conversion options. Thus, if all conversion rights were exercised as regards New Inverness, Chapman's shareholding would fall to 3.1%. The value of Chapman, and therefore of Mr MacArthur's shares in Chapman, would decrease accordingly.

Mr MacArthur also owned preference shares in Chapman and New Inverness. The value of these shares had been agreed in correspondence between 1994 and 1996.

**Issues arising**

The main issues were:

- (a) whether the existence of the loans could have been established and whether the conversion rights had prescribed;
- (b) whether the lack of sufficient authorised share capital in New Inverness to allow all the conversion rights to be exercised was relevant; and
- (c) what discounts should be applied to the *pro rata* value of the companies in respect of each of the shareholdings.

Point (b) was resolved in advance, by the agreed facts. It was agreed that

under the Companies Act as in force in 1994, and on the application of New Inverness's articles of association, a person holding Mr MacArthur's shares and loans could have forced the creation of sufficient authorised share capital to enable the conversion rights to be exercised fully.

Point (c) was resolved in favour of HMRC. As the Special Commissioner said:

Valuation, being an art, rather than a science, in which mathematical certainty cannot be achieved, the difference between the two experts is perhaps what one might expect.

*Scots law has rules of prescription. The effect of prescription (in the context of contractual obligations) is to extinguish a right so that it no longer exists.*

Clearly, there can be no 'correct' value; there is always room for difference of opinion. There is an element of discretion based on experience and the application of guiding principles (rather than inflexible rules) to the particular facts relating to the unit of valuation.

For a shareholding of just over 25%, the Special Commissioner accepted HMRC's proposed discount of 45% to a pure net assets value. For a shareholding below 25%, again HMRC's position was accepted, this time of a discount of 65%.

Point (a) merits more detailed attention.

**Did the loans exist?**

Regarding whether the loans and conversion could be proved to have been created, the Special Commissioner found enough evidence to be satisfied that any doubt would not affect their valuation. The minutes recording the making of the loans and the grant of the conversion rights still existed, even though no contracts were made in writing. This satisfied the rules of formal validity in Scots law applicable at the relevant time (the 1960s and early 1970s). The companies had made various references to the loans and the conversion rights in their annual

accounts. These could be used as evidence that the loans had been made.

**Prescription**

The next issue was prescription. English law recognises only rules of limitation. These prevent a person from raising an action to enforce an existing right, but do so without affecting the existence of the right itself. By contrast, Scots law has rules of prescription. The effect of prescription (in the context of contractual obligations) is to extinguish a right so that it no longer exists.

The parties agreed that as of Mr MacArthur's death the conversion rights had not prescribed: they still

existed and could be exercised.

However, the appellants had obtained a solicitor's opinion that prescription had operated. The appellants then obtained counsel's opinion to the opposite effect, but acknowledging that the issue of prescription was 'a delicate one' and there was 'room for an argument' that the conversion rights had prescribed. This led to the issue of whether this doubt about prescription should affect the valuation of the conversion rights.

The Special Commissioner analysed whether prescription had operated so as to extinguish the conversion rights. He agreed with the parties that it had not.

He went on to decide that there was no real uncertainty on the prescription issue. Therefore, there was no scope for reducing the value of the conversion rights on account of the possibility that they had been lost through lapse of time. But some interesting points arise concerning how one determines whether there is doubt about legal matters.

HMRC submitted, and the Special Commissioner accepted, that the opinion the taxpayers had obtained from counsel was irrelevant and the issue was one of law for the Special Commissioner to decide. So the fact that counsel had said that the issue was delicate and that there was room for an

argument in favour of prescription did not matter. But this decision is not as clear as it sounds.

There was no dispute that, had there been genuine doubts about prescription, they should have been taken into account as reducing the value of the shares. This is certainly correct. The question to be answered is how much a hypothetical purchaser

tribunal, as of the date of valuation it is unanswered. That is why in actual transactions purchasers of companies obtain due diligence reports from solicitors on legal matters, including (for example) the rights attaching to the shares they intend to buy. There is no guarantee that what is reported by such due diligence processes is correct. There is no reason to make the

parties whose interests are directly affected by the legal point at issue is represented. The question of whether the conversion rights had prescribed would come up in a disagreement between the holder of the rights and the company. Although the former's representatives appeared before the Special Commissioner, they were arguing against what they would have been arguing 'normally'. And the company, of course, did not appear at all.

How does one decide whether relevant doubts exist? Part of the answer is clearly to refer to the tribunal's view of the law. But, again, that view is reached in a particular setting, where the point has been argued (if not on behalf of the parties who would in fact argue it). Moreover, that view is aimed at ascertaining what information would have been available to a hypothetical purchaser at the date of valuation. There must be at least some scope for having regard to the opinions of lawyers actually given, albeit not to a hypothetical purchaser (of course) but before the tribunal's decision, as in some way showing what advice a hypothetical purchaser might actually have received. So there must be scope for having regard to an opinion actually obtained from counsel.

In addition, the taxpayers led expert evidence from a practising corporate lawyer, who regularly advised individuals contemplating purchasing shares and other securities, including loan stock. His evidence was clear that, given the various difficulties with the loans and the conversion rights (their somewhat informal nature, the limited evidence of their existence, the prescription issue, doubts about whether the companies could defeat the conversion rights by tendering repayment, and so on), in reality nobody would buy them for a price calculated 'as if' the loans had been converted. In practice, the purchaser would require the seller to convert the loans first, and would then buy the shares. This evidence suggested a significant discount. But the Special Commissioner decided to leave this evidence out of account. This was because the advice that would be given would be not to go ahead, whereas the issue was to value an asset that must be treated as having to be sold.

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in the open market would pay for the shares. Such a purchaser would not have the decision of a court on any doubts about the legal rights they were acquiring. So, although a legal issue is, by its nature, a question of law which can be answered by the relevant

hypothetical purchaser pay more than a real purchaser would, simply because a question to which a real purchaser could not, at the relevant time, obtain an answer, can be answered by the tribunal after the event. Moreover, before the tribunal only one of the

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However, the fact that statute requires a hypothetical sale does not render irrelevant evidence that in the real world no buyer would have purchased the asset as it stood. Even if this does not necessarily force the conclusion that the asset should have a nil value, it is clearly a factor that points to a large discount on the value being appropriate. Although, by its nature, the hypothetical purchase does not take place in the real world, the task of valuation requires as close an approximation as possible to it. So the fact that in reality a purchaser would not buy the loans but would require them to be converted and would then buy the shares suggests at least some discount for the hypothetical purchaser forced to buy the loans and hoping to then convert them into shares.

**Objectivity of experts**

One point made by the Special Commissioner concerned the need for an expert to maintain not just objectivity but the appearance of objectivity.

The valuation expert the taxpayers used had attended various meetings with HMRC, and had engaged in a fairly lengthy correspondence with them. This is entirely normal. But one of the major points he relied on for arguing for a larger discount on the value of the shares was the possibility that the conversion rights had prescribed. Counsel's opinion was obtained, and he concluded that the rights had not prescribed. However, counsel indicated that the matter was 'a delicate one'. The function of an expert witness is to receive information and to give an opinion on the basis of that information. But in this case the valuation expert, as the Special Commissioner saw matters, 'descended into the arena'. For after receiving counsel's opinion, the expert attended a conference with counsel. It appeared from the notes taken that the purpose of the conference was really to test counsel's opinion and, again as the Special Commissioner saw it, persuade him to change his mind.

Naturally, this did not impress the Special Commissioner. He said:

Why [the expert] attended the consultation is unclear. All he required was a statement of the law which he was to assume for the purposes of his

valuation. He did not need to descend into the arena and discuss questions of law with counsel with a view perhaps to making him change his mind. An expert who does that loses a degree of independence which he might otherwise have. A court or tribunal will examine the evidence of such an expert with care.

Indeed, the Special Commissioner ultimately accepted HMRC's expert's view in preference to that of the taxpayers' (although the reasons for that were the irrelevance of a number of the factors that the expert had said

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should decrease the value of the shares and the conversion rights).

In any event, fundamentally the advice that would be received by an interested buyer on the issue of prescription was one of the facts of the case. It was outside the proper scope of the expert's duties to seek to influence it. If an expert appears to be willing to test the assumptions on which they were to base their opinion, and to seek to change them to make them more favourable to the case of the party engaging them, this is likely to reduce the weight given to their opinion. This is particularly important in a field such as share valuation. This is because, although there are factors to be taken into account that can point one way or another in terms of the value of shares, the end result does have a reasonable element of judgement or 'feel' to it. But this does not make it unimportant in relation to expert opinion in more empirical fields. An expert must always be very careful to keep within the proper limits of their task. This is necessary if their objectivity is not to be called in question.

**Investigation and planning**

Finally, could this case have been avoided? There was certainly a way in which some of the value in the conversion rights could have been

passed to the next generation without any inheritance tax. Unfortunately, it depends on the particular circumstances of the case.

Had Mr MacArthur simply agreed with the companies (over which he exercised day-to-day control) that they should repay the loans, then value would have been passed from him to the other shareholders. The other shareholders included his son. The repayment of the loan would have been a commercial transaction by a close company. It would have been outside the scope of inheritance tax:

the value of the companies' estates would not have been diminished. Even if the companies' estates were somehow diminished, the repayments of the loans would probably have been exempt as commercial transactions not intended to confer a gratuitous benefit on anyone. Even if repayment of the loans included an omission by Mr MacArthur to exercise his conversion rights, and that, together with repayment, were treated as associated operations producing a transfer of value (although it is difficult to see what the transfer would have been), there would have been a potentially exempt transfer. If Mr MacArthur had sought inheritance tax planning advice early enough, around £200,000 of tax could have been saved.

Of course, a fairly detailed investigation of Mr MacArthur's assets would have been required. The conversion rights could easily have been missed, and the particular opportunity is entirely bound up with the facts of the case. Nonetheless, it does demonstrate that early and thorough tax planning can be extremely beneficial. ■

*Executors of MacArthur (dec'd) v HMRCC [2008] WTLR 1185*