MARKET VALUATION: *CONTENDERS FOR THE ROLE OF HYPOTHETICAL BUYER*[1]

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The recent decision of the Special Commissioner in *Executors of Marjorie Edna Bower (Deceased) and others v HMRC* (SpC 0665) provides further illumination on the problematic and sometimes artificial exercise of market valuation. Whilst the question here arose in the context of Estate Planning Bonds, the points arising are clearly of wider relevance.

The Facts

The question on appeal was as to what value should be placed on the reserved rights to a life annuity under a policy known as an `Estate Planning Bond' (elsewhere referred to as `Discounted Gift Schemes') taken out with AXA Isle of Man. The policy in this particular case was taken out by Mrs. Bower, a lady of 90 years of age. Mrs. Bower paid a premium of £73,000 herself and the policy was issued to the trustees of a settlement previously declared by her. Her reserved rights under the trust were simply to a 5% life annuity (equivalent to withdrawals of £304.16 per calendar month). It was implicit that on her death, the remaining investments allocated to the policy after payment of the annuity would pass to the trustees of the settlement for distribution amongst the other beneficiaries. Mrs. Bower died approximately 5 months after taking out the policy.

The Issue

It had been accepted by HMRC that the 5% annual withdrawals under the policy, being the sole entitlement of Mrs. Bower under the trust, would be tax free and would occasion no liability for higher rate tax as `chargeable events' under the income tax provisions relating to insurance policies. In the context of inheritance

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tax, as Mrs. Bower had died well within the 3 year period following the making of PETs, it followed that there had been a chargeable transfer. The question arose as to what the value of that transfer was. It was accepted that, as Mrs. Bower's reserved rights were clearly defined, there would be no question of her being treated as having made the gift with a reservation of benefits such that the whole premium would be counted. It was also commonly accepted that she did not have a life interest in the whole of the settlement and was therefore not to be treated as being beneficially entitled to all the settled property. Finally, the parties also agreed that the amount of the gift was the £73,000 premium less the market value of the reserved rights to the life annuity. Where the disagreement did arise was as to the market valuation of the reserved annuity rights under section 160 Inheritance Tax Act 1984.

Prior to issuing the bond, AXA Isle of Man had considered the report from Mrs. Bower's doctor and had assessed her state of health and life expectancy. It had been decided that her medical reports justified loading her age and treating her, for life expectancy purposes, as if she were 103 rather than 90 and with a consequent life expectancy of two to three years. But even when predicating their valuation on her particular waning state of health, they determined that a life expectancy of two to three years, when coupled with the fact that the monthly payments were of £304, gave the value of £7,800 and, accordingly, issued a Certificate of Value to that effect (indicating that the value of the gift was £62,500).

This valuation was disputed by HMRC who took an altogether different approach. They first declared in the antebellum that the reserved rights had no value at all and that the amount of the gift was thus £73,000. However, in their Notice of Determination, the value of the rights was revised to give £250 (so that the gift would be treated as £72,750). One stark difference between the two approaches was that in cases involving persons over the age of ninety, HMRC did not take the particular characteristics of the life assured into consideration. They had previously stipulated in a Technical Note that *in each case* where an Estate Planning Bond was issued to a person over the age of ninety, the value of that person’s rights was to be treated as being nominal. This on the ground that genuine life assurance would not be commercially available for the life of such a person and as any buyer of the annuity rights would wish to lay off the mortality risk by taking out life assurance in relation to the life of the annuitant, the absence of cover would make the annuity rights effectively worthless.

The executors of Mrs. Bower’s Estate appealed the HMRC valuation. The appeal was heard before Special Commissioner Howard Nowlan in London on 18th October 2007.

The HMRC Case

As stated above, the primary contention of the HMRC was based on the near impossibility of obtaining life cover for a person over the age of ninety. It was contended on their behalf that, whilst there was very little actual experience of the secondary purchase of *life annuities*, there was considerable experience in relation to the valuation of *life interests* in settled property. Life interests are often valued for the purposes of either splitting settlement assets between the life tenant and remaindermen or simply with a view to their purchase by third parties. Foster & Cranfield had, since their formation in 1883, been involved with such valuations in relation to the purchase of life interests in settlements and it was their expert opinion that the buyer of a life interest would almost invariably wish to lay off the mortality risk by taking out term life insurance on the life of the life tenant. All experience however suggested that it was extremely difficult to obtain term life cover in respect of a person over the age of 80 and virtually impossible to obtain it in respect of a person over the age of 90, let alone for a person at that age in questionable health and who was treated for life expectancy purposes as if they were 103. In the absence of life cover, no buyer would be willing to pay a significant amount for the value of a *life interest* held by a ninety year old. By analogy, the inability to obtain life cover on the life of such a person also meant that the value of a *life annuity* taken out by him or her was also reduced to exiguity.

In addition to the unmitigability of mortality risk, HMRC produced three further arguments to buttress their position. First, that there was no ground for supposing that the purchaser could spread the mortality risk by buying other annuities in respect of persons of similar, or indeed, any other ages. Second, that the value would have to be reduced by costs relating to the purchase. Any buyer would be cautious about accepting the medical judgment given by AXA Isle of Man, since AXA Isle of Man was commercially indifferent to when the life assured might die and indeed had an incentive (in the interests of saving inheritance tax for its clients) to exaggerate the life expectancy of the life assured and thus the value of the life interest. A hypothetical buyer would therefore want to obtain independent medical opinion. In addition to the medical costs, the legal costs of ensuring that the assignor owned the right to the life annuity and that the annuity was validly assigned were asserted to be in the order of £1000 using non-City lawyers and £2000 using City lawyers. Third, a buyer would also observe that life expectancy tables became much less accurate as age increased and that the figures of life expectancy for 90 year olds were based on a mix of sparse information and extrapolation of figures for other age groups. These factors, they contended, were cumulatively of such a detrimental effect that they drummed down the value of the reserved rights to an effective nullity.

The Executors' Case

The executors were represented by Rex Bretten QC and Setu Kamal. The commonly agreed principles of valuation were adduced on their behalf. Accordingly, it was contended that it was necessary to estimate the price that the rights would fetch in a transaction between a `willing seller' and a `willing buyer', each acting reasonably and seeking to secure their best interests. The notional transaction in which that price was to be ascertained was a transaction that had to be treated as occurring, and it was irrelevant the particular present owner of the annuity would not wish to sell it at all so that no sale would take place.

It was accepted that insurance companies would be very unlikely to issue a genuine term life assurance policy in respect of the life of a person with an age in excess of ninety years, and all the more so for a person with a weighted age treated as one hundred and three. It accordingly followed that even though purchasers of life interests in settlements generally laid off the mortality risk when buying a life interest by taking out reducing term life insurance cover in respect of the person whose life interest in settled property was purchased, such an approach would not be possible in this case. Notwithstanding this point and notwithstanding, also, the ontological observations that there were no actual markets and no market experience available for and in relation to the sale and purchase of annuities taken out by people of the age of 103, one still had to judge what price was most likely to be paid in the transaction that had to be assumed to take place. The criteria to apply, in cases where the buyer would not be able to purchase other similar annuity rights so as to "pool" risk, were to assess a life expectancy for a 103 year old female life from available mortality tables, reduce the value by a much higher interest rate of 15% p.a. to reflect the greater risk resulting from the absence of life cover and of pooling, and then the deduct purchaser's costs (which were presumed to be £500). This approach placed a minimum value of £6,277 on the annuity.

The Decision

Special Commissioner Nowlan pointed out that this was a curious case in that there was little dispute as to the legal principles to be applied. Before addressing the particular bone of contention, he applied the various principles which it was agreed did apply here. First, it was to be presumed that the property is sold. The fact that a 90 year old who had just taken out a life annuity, whilst divesting herself of other property (so that the annuity receipts would fund her living expenses) would never sell the annuity or else would be such an unwilling seller that she would only sell at a very high price, were both irrelevant. Second, the property to be valued was Mrs. Bower's individual life annuity and not a massive block of business being sold by one insurance company to another. Third, the valuer must thus proceed on the basis that no buyer would be able to lay off the mortality risk by taking out term life assurance. Fourth, that the buyer might be cautious of adopting the life expectancy conclusions adopted by AXA Isle of Man. Whilst AXA Isle of Man had approached the valuation with a view to providing a reliable valuation of the annuity for inheritance tax purposes, it was nevertheless the case that AXA Isle of Man would have been in no different position had it indicated a likelihood that Mrs. Bower would die after one week or only when achieving the age of one hundred and twenty (save that in the one case it would doubtless have earned more profit from having managed the investments for a longer period of time). A buyer might well also have observed that life expectancy tables were very unreliable for people in the age group over ninety. Whilst this would increase risk, improvements in general health, care and medical treatment would also mean that as against statistics complied some time ago, life expectancy had generally increased. Fifth, that any buyer would reduce the purchase price to be given for the annuity in order to provide for the expenses of purchase. Whether those would include the cost of any further medical opinions or whether they would just include legal expenses was debateable. It will be seen that the overall effect of the Special Commissioner's acceptance of these points is deflationary.

Having decided most of these points in favour of HMRC, Special Commissioner Nowlan finally turned to the pivotal question of life assurance. It was the experience of Foster & Cranfield that in valuing life interests in settled property, purchasers almost invariably wish to lay off the mortality risk by taking out genuine term life assurance. He accepted that such assurance would not be available in the present case. However, he ultimately concluded that the unavailability of life assurance, whilst atrophying, was not obliterating. His reasoning was as follows. Whilst the market valuation procedure postulates an open market sale, there is no requirement that the sale must be envisaged as taking place in some sort of conventional manner. He states:

> "It thus seems realistic in this case to say that the buyer need not necessarily be of the risk-averse category who would lay off the mortality risk, and then run fairly conventional discounting calculations, but might more appropriately be a *speculator*."

In other words, where the commercial realities are such that the purchase cannot be pictured as having been made by a traditional, risk-averse investor, then, given that a sale is hypothesized, it may be more appropriate to characterise the hypothetical purchaser as a `speculator'. Once the identification of the purchaser as a speculator has been made, the rest of the solution falls into place. The most obvious implication is that the element of risk does not of itself render the value of the rights nugatory. The Special Commissioner states at paragraph 30:

> "In further support of that I observe that many people are prepared to risk very significant amounts of money on bets of the most extraordinary nature…I now need to consider at what price I consider it reasonable to

> suppose that a willing *speculator* would have been prepared to buy and a willing seller prepared to sell."

He took as his starting point the figure of £7,800 – which was the predicted return based on Mrs. Bower's health-adjusted life expectancy. He then reduced this by one-third to reflect the various uncertainties:

> "I still consider that the *speculator* would just seek to reduce the price paid by an amount to reflect the mortality risk, the inaccuracy of life expectancy tables, the possible lack of competing purchasers, the possible doubts about medical opinions, and the discounting for time. I think that a reduction of one third is reasonable."

Finally, he reduced that figure by £1,000 representing legal expenses. This left the figure of £4,200.

Author's comments

The Special Commissioner's method resulted in a valuation at £4,200 – a figure more than fifteen times that proposed by HMRC. The immediate impact of this decision is that it will reduce the inheritance tax payable on all the chargeable transfers which have been made in connection with Estate Planning Bonds by individuals over the age of 90. However, its significance to the question of valuation is not restricted to such bonds and extends to any such case where the commercial context is such that the hypothetical sale is hard to envisage and, in particular, where it is hard to envisage the traditional, risk-averse purchaser entering into a transaction (due to either the unmitigability of risk or any other reason).

The market value rule has sometimes been misunderstood by some as harbouring an inherent paradox as it requires a marriage of two seemingly irreconcilable propositions, namely, that the value genuinely reflect the commercial verities of the market and that there be assumed to be a sale between willing purchasers and sellers. But on closer inspection what appears from a distance to be an inexpugnable conundrum unravels to provide no real problem at all – there is no paradox because whilst both the sale and willingness of the parties is assumed, what is not assumed is the *degree* of willingness on the part of the respective parties to part with and acquire the said asset.

In the present case, HMRC purported to make obligatory obeisance to the commerciality principle by contending that the asset here was not of a kind which the traditional purchaser of such assets would want to buy without some form of insurance and, accordingly, that the value of the asset was peppercorn. In the author's view the Special Commissioner exhibited a more sedulous commitment to the commerciality principle by accepting that, whilst a traditional investor may not wish to purchase the asset on such terms, a speculator may well do so. The characterisation of the buyer here as a speculator not only did away to the objection relating to the lack of insurance but also pervaded the Special Commissioner's overall method (for instance, his doing away with medical opinion fees and his rejection of complex interest reductions). When assessing the Commissioner's approach, his reduction of one-third should be seen as principled rather than pragmatic. It more closely describes how a speculator would think.

One wonders whether the HMRC position was inadvertently etiolated by their own claim that Mrs. Bower's annuity would not have been of interest to a traditional purchaser of life-interests. Being occluded from making a comparison with such a purchaser, the Special Commissioner was forced to look to the comparatively unbridled model of speculator for guidance. Of course, the supplantation of the average investor by the speculator does not permit a valuer to do away with all semblance of commercial restraint (and the Special Commissioner was careful here to make reductions for the various uncertainties and costs). It is also arguable that the Special Commissioner could have arrived at a similar position through another route – namely, by taking the figure which a traditional purchaser would have paid and then reducing it to take into account the risk. However, given the emphasis placed by the decision on the characterisation of the buyer as a speculator, one wonders whether this approach would have resulted in quite as high a figure.