The Personal Tax Planning Review

"MARKET VALUE": WHAT DID *IRC v CROSSMAN* DECIDE?

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1 Scope of the Article

IRC v Crossman[2] was decided by a 3-2 majority of the House of Lords in 1936 on estate duty provisions now repealed. It is generally thought to be still authoritative on the meaning of "market value" for capital gains tax and inheritance tax purposes. In this article, I suggest that the scope of the principle of valuation there laid down has been sometimes misunderstood by those who have not considered the actual speeches carefully enough and that it is narrower than generally thought. I firstly discuss the case itself and then two Court of Appeal decisions in inheritance tax, *Alexander v IRC*[3] and *Walton v IRC*.[4]

2 The Decision in *Crossman*

2.1 The Head Note

The following is taken from the head note to the Law Reports report of the case:

> "By s. 7, sub-s. 5, of the Finance Act, 1894, "the principal value of any property," which passes on the death of a person dying after the commencement of Part I of the Act, "shall be estimated to be the price which, in the opinion of the Commissioners, such property would fetch if sold in the open market at the time of the death of the deceased." ....

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2 [1937] AC 26.

3 [1991] STC 112.

4 [1996] STC 68

> "A testator at the time of his death was entitled to a number of ordinary shares of £100 each in a company the articles of association of which imposed rigid restrictions upon the alienation and transfer of the shares in the Company:
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> "Held, by Viscount Hailsham L.C., Lord Blanesburgh and Lord Roche (Lord Russell of Killowen and Lord Macmillan dissenting), that the value of the shares for the purpose of estate duty was to be estimated at the price which they would fetch if sold in the open market on the terms that the purchaser should be entitled to be registered and to be regarded as the holder of the shares, and should take and hold them subject to the provisions of the articles of association, including those relating to the alienation and transfer of shares in the company."

While the head note is entirely correct as far as it goes, it is inadequate. It states the result of applying the principle to the facts of the case and not the principle itself.

The similarity between Finance Act 1894 section 7 and the corresponding inheritance tax and capital gains tax provisions will be readily appreciated. Inheritance Tax Act 1984 section 160 (market value) provides:

> "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."

Taxation of Chargeable Gains Act 1992 section 272 (Valuation: general) provides:

> "(1) In this Act "market value" in relation to any assets means the price which those assets might reasonably be expected to fetch on a sale in the open market.
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> (2) In estimating the market value of any assets no reduction shall be made in the estimate on account of the estimate being made on the assumption that the whole of the assets is to be placed on the market at one and the same time ..."

2.2 Property Subject to Forfeiture on Assignment

One can test the true scope of the *Crossman* principle by asking: "What effect does an absolute covenant against assignment have on the "market value" of a lease?" In my view, it enormously reduces its value, as no one would normally pay a penny to take an assignment of the lease since the landlord could thereupon immediately forfeit it, unless, of course, the landlord were prepared to waive the breach. What difference does the *Crossman* principle make? In my view, none. *Crossman* decided merely that the statute, by adopting the concept of a hypothetical sale, requires one to posit that a sale on the open market can take place even when it cannot in reality. In that case, shares which fell to be valued were subject to restrictions on alienation. It was held that it must be assumed that they could be sold to anyone but that in valuing how much a purchaser would pay for them one should take into account that he too would be subject to the restrictions. In my view, that principle does not begin to apply in the case of a lease subject to a covenant against assignment as, unlike the shares in *Crossman*, it is perfectly capable of assignment. It is simply that assignment will expose it to a risk of forfeiture, a risk the importance of which will vary from case to case.[5]

3 An Analysis of *Crossman*

3.1 Viscount Hailsham

Viscount Hailsham LC pointed out that it was upon the construction of Finance Act 1894 that the question ultimately depended. Under section 7 the Commissioner of Inland Revenue had to estimate the price which the shares would fetch if sold in the open market at the time of the death of the deceased. Under the articles of the company it was not possible to sell the shares in the open market until they had been offered to and refused by the existing shareholders. In order, therefore, to comply with the provisions of section 7(5) it was necessary either to assume a sale in the open market of the shares, or else to limit the property to be valued to that which could be sold in the open market.

In disagreeing with the Court of Appeal, who had preferred the latter alternative, he said:

> "My Lords, it seems to me that this construction involves treating the provisions of s. 7, sub-s. 5, as if their true effect were to make the existence of an open market a condition of liability instead of merely to

[5] The Lands Tribunal for Scotland appears to have been of a contrary view in *Baird's Executors v IRC* [1991] 1 EGLR 201.

> prescribe the open market price as the measure of value ... But the purpose of s. 7, sub-s. 5, is not to define the property in respect of which estate duty is to be levied, but merely to afford a method of ascertaining its value. If the view entertained by the Court of Appeal were correct, it would follow that any property which could not be sold in the open market would escape estate duty altogether ... I can see no difficulty in treating the subsection as meaning that the Commissioners of Inland Revenue are to assume that the property which is to be valued is being sold in the open market and to fix its value for estate duty purposes upon that hypothesis ... In order to comply with that statutory direction, it is necessary to make the assumptions which the statute directs."

3.2 Lord Blanesburgh

While Lord Blanesburgh's speech is long and rambling, the ratio of his decision was the same as that of the Lord Chancellor. He cited with approval Chief Baron Palles' speech in *Attorney-General for Ireland v Jameson*:[6] "The whole judgment of the Chief Baron I have found to be a masterly presentment of the problem before the House ..." Lord Blanesburgh remarked that after saying that the supposed sale was being made in the open market on the assumption that the open market is available, the Chief Baron proceeded: "And upon this assumption, which is the supposition the statute directs us to make, we must exclude the consideration of such provisions in the articles of association as would prevent a purchaser at the sale from becoming a member of the Company, registered as such in respect of the shares purchased by him at such supposed sale. If we do not, we do not give effect to the assumption the statute coerces us to make."

3.3 Lord Roche

Lord Roche also "arrived at a definite conclusion that the appeals should be allowed for the reasons expressed by the Lord Chancellor ..."

3.4 Conclusion

It is in my view very clear once one reads the case that the *ratio* was that where a statute hypothesises that an asset is sold in the open market, then it is impliedly bidding one to ignore any facts inconsistent with that hypothesis, but that is the limit of the statutory fiction.

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6 [1905] 2 I R 218.

3.5 *Alexander v Inland Revenue Commissioners*

In *Alexander v Inland Revenue Commissioners*,[7] the Court of Appeal apparently extended the *Crossman* principle to bizarre lengths. The decision is best understood on the basis that a litigant in person was pitched against (now Leading) Counsel and that the point whether *Crossman* applied on the facts of the case received no independent consideration.

In 1983, the deceased acquired a leasehold interest in a flat for a consideration of £35,400 pursuant to the 'right to buy' provisions of the Housing Act 1980 at a discount of £24,600. The lease contained a covenant by the tenant to pay the landlords the relevant percentage of the discount if, within five years of the grant of the lease, there should be a disposal falling within the terms of the covenant. The liability to pay was a charge on the leasehold. The deceased died on 17th January 1984, on a sale at which time an amount equal to 100% of the discount would have become payable. Issues arose concerning the respective jurisdictions of the Lands Tribunal and the Special Commissioners. Both tribunals considered that it was the function of the Lands Tribunal to value the lease ignoring the covenant to repay the discount to the landlords and for the Special Commissioners to value the obligation to repay the discount, which value would then be deducted in valuing the estate of the deceased immediately before her death and thus the value deemed to have been transferred by her at that time. The Special Commissioner decided that the value of the liability to repay the discount was the full amount which would have been payable if there had in fact been a sale on death. This result was entirely just. As Nicholls LJ observed at 124f-g:

> "At first sight the executor's case is attractive: it cannot be right that, for capital transfer tax purposes, the lease should be valued in a sum greater than could have been obtained had the lease been sold at the time of the death. Had the lease been sold, the relevant repayment of discount would have become due and payable. Tax ought not to be payable on a greater amount than the net sum which, in the event of such a sale, would have been received by the deceased's estate. Neither she nor her executor could have obtained more than the net sum."

Yet there were technical difficulties and practical difficulties. From a practical point of view, it is clearly undesirable for two tribunals to be involved in what is basically one exercise. Technically, it is difficult to justify the Special Commissioner's decision that the liability to repay the discount was to be valued on the basis of an actual sale on death. Instead, it was only a contingent liability and its value should thus have been discounted. The valuation provisions of capital

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7 [1991] STC 112.

transfer tax (and inheritance tax) were taken from estate duty, where one was concerned with the value of property which "passed" on a person's death. Liabilities were expressly dealt with elsewhere. Under capital transfer tax/ inheritance tax one is concerned with the value of the deceased's estate immediately before his death. While the estate duty provision for valuing assets on the basis of a hypothetical sale is incorporated, there is no corresponding hypothetical sale when it comes to valuing liabilities.

On an appeal from the Lands Tribunal decision, the Court of Appeal[8] decided that the Lands Tribunal had exclusive jurisdiction (and thus the Special Commissioner had no jurisdiction) because the property to be valued was one item, namely land, being the lease subject to the incumbrance of the charge securing repayment of discount. Thus the property should be valued taking into account the liability to repay the discount. This decision so far was clearly a sensible one.

Application had been made for leave to amend the case stated by adding the following additional questions for the opinion of the court, namely: Whether the entity to be valued is the lease taking into account the obligations of the tenant and her successors in title to make repayments to the landlords under the provisions of the Housing Act 1980; and, if so, whether the principles exemplified in *IRC v Crossman* [1937] AC 26 are applicable. The executor did not resist the making of the amendment and leave was granted. The Court of Appeal then went on to consider the *Crossman* point. The focus of their attention appears to have been whether the *Crossman* principle was applicable to capital transfer tax. Unsurprisingly, they decided that it was. They then took an intellectual leap explicable only on the basis that the executor was completely out of his depth and that the real point was not argued. Ralph Gibson LJ said at 123e-f:

> "I have no doubt that the principles stated in *Crossman*'s case are applicable to section 38 of the 1975 Act[9] which in substance is the same as section 7(5) of the 1894 Act[10] with words which were originally added to give statutory recognition to the decision of the House of Lords in the *Duke of Buccleuch*'s case. *It follows*[11] that, in valuing that which passed from the deceased on the deceased's transfer of value immediately before

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8 Ralph Gibson LJ, Nicholls LJ and Sir Denys Buckley.

9 The Finance Act 1975. Section 38(1) was the predecessor of Inheritance Tax Act section 160.

10 The Finance Act 1894, which contained the core estate duty code.

11 Italics supplied.

> her death under section 22, in order to determine the amount by which the value of the estate is less by the transfer, the Lands Tribunal are required to determine the amount which, on a hypothetical sale, a person would be willing to pay to acquire the lease held by the deceased subject to the obligation which would fall on the hypothetical purchaser to make a repayment to the landlord in the event of a disposal within s 8(3) of the Housing Act 1980 but on the footing that his own hypothetical acquisition did not itself give rise to such a disposal."

With respect, from the proposition that the *Crossman* principle is applicable to capital transfer tax it does not follow for one moment that the lease was to be valued on the basis that a sale of it would not trigger the obligation to pay the landlord but that the purchaser would be under such an obligation if he in turn were to sell. In my view, the sole factor on which the House of Lords relied in *Crossman* to justify an artificially inflated value for estate duty purposes was that, as the statute postulated a sale in the open market, therefore, if no such market in reality exists, one must deem it to exist; one is not permitted to substitute a test of what price would have been fetched in the closed market of reality. Their decision does not in my view justify any further departure from reality.

Now the lease in the present case was fully assignable. There was no need and no occasion to invoke *Crossman*. The question to be posed is a perfectly simple one: what would a purchaser pay for a lease which unencumbered was worth £63,000 if on its acquisition it would become subject to a charge for £24,600? The answer is clearly £38,400.[12]

Moreover, the manner in which Ralph Gibson LJ considered that *Crossman* should be applied indicates that no great attention was paid to this aspect of the case. The reason their Lordships in *Crossman* required one to take into account that the purchaser would be subject to restrictions on alienation was that that was the reality of the case and nothing in the statute required one to depart from that reality. If the articles had provided that the restrictions on alienation were to apply only while the deceased was the holder of the shares, then they would have been completely disregarded in calculating what a purchaser would have paid for them. Now in *Alexander* the purchaser would not have been subject to restrictions. The sale to him would have triggered the obligation to pay a sum to the landlord once and for all. There is no warrant in *Crossman* for introducing into the statutory hypothesis this completely artificial element When one is dealing with a statutory hypothesis, one must deem all the necessary consequences of the hypothesis to

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12 The position is of course distinguishable from the case where property is already subject to a charge before it is sold and it is a term of the contract of sale that the vendor sells free from encumbrances.

exist unless that leads to injustice or absurdity or would defeat the manifest purpose of the statute. See *Marshall v Kerr* in the Court of Appeal,[13] approved on this point by the House of Lords.[14] In this case, the hypothesis of a sale on the open market, so far from requiring one to assume that the purchaser would be thereafter subject to restrictions to which no purchaser would in fact be subject, necessarily involves the contradictory assumption, namely, that there having been a sale, the assignee of the lessee, being a purchaser, is freed from the restriction to which he would have been subject only if he had been a volunteer.

The Court of Appeal therefore did not just[15] apply *Crossman*. They created a new principle of completely uncertain scope that even where property can be sold in the open market, as the lease could in this case, the reality of certain depreciatory elements is to be ignored in the valuation process. They gave us no guidance as to how these elements can be identified.

Nor do the other judgments give any cause to doubt my conclusion. Nicholls LJ clearly did not concentrate his mind either on whether *Crossman* was applicable to the facts of the case. His main concern was to state, quite unexceptionably, the basic principles of valuation and to arrive at the conclusion, at 125g-h, that the lease was a lease of land and thus the valuation exercise concerned the value of land, so that an appeal lay exclusively to the Lands Tribunal. He then added, almost as an afterthought:

> "Clearly, in carrying out this valuation exercise it may well be convenient and sensible for the Lands Tribunal to consider, first, how much the lease would be likely to have fetched if sold in the market on 17 January 1984 but disregarding the subsisting discount repayment liability and, second, the amount by which this price would be likely to be reduced if the notional purchaser who acquired the lease did so subject to an obligation to make repayments as provided in the lease if thereafter there were to be a disposal of the lease as defined in the 1980 Act and reproduced in clause 3 of the lease. But the exercise remains exclusively 'a question as to the value of land' even if the route followed in making the valuation involves two steps such as these."

Thus, he too failed to consider the key question. Sir Denys Buckley agreed with both judgments.

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13 [1993] STC 360.

14 [1994] STC 638.

15 Subject to the argument, discussed below, that it is no part of the *ratio* of the case.

Now it could be argued that *Alexander* is authority for the proposition that in valuing a lease subject to a covenant against assignment one is to disregard the breach of covenant to which the statutory sale might give rise. While the two cases are not the same, *Alexander* can be justified only on the basis of some very wide principle which could indeed justify both the decision itself and the proposition. My own view is that the wrong result was reached in *Alexander* but *per incuriam*. It is not just that the point was not competently argued by the taxpayer: it appears not to have been argued at all. Thus the case is no authority at all on *Crossman* beyond the point that it is applicable for capital transfer tax, and thus inheritance tax, purposes.

3.6 *Walton v Inland Revenue Commissioners*

In *Walton (Executor of Walton deceased) v Inland Revenue Commissioners*,[16] the deceased had farmed in partnership with his son, J. He and his two sons, J and F, owned in equal shares the freehold of the farm which by an agricultural tenancy agreement they had let to the partnership on a yearly tenancy, subject to a covenant against assignment without the consent of the landlords. The Revenue claimed that the value of the deceased's share in the partnership included an amount in respect of the tenancy to be derived from the larger of half the open market value of the tenancy and half of what a landlord would have paid a tenant for the surrender of the tenancy. They calculated that the landlord would have paid £100,000, being one-half of the marriage value, or vacant possession premium. They then allowed a 10% discount from the £100,000 'to reflect the assembled nature of the partner's interest in the underlying property', and halved the resultant figure of £130,000. The deceased's executor contended that the property to be valued under Finance Act 1975 section 38(1)[17] was the deceased's share in the partnership and not any separate share and interest in the individual assets and that the tenancy as such did not have to be valued. The Lands Tribunal accepted that the real landlords would have paid nothing to obtain vacant possession.

The Court of Appeal held, quite correctly, that what fell to be valued was not the tenancy as such but the deceased's interest in the partnership which owned the tenancy. They also held that the open market hypothesis in section 38 did not require that the landlord should be hypothetical; it assumed a sale in the real world, so that if the actual landlord were not both able and willing to pay for vacant possession, he should be disregarded in applying the hypothesis. It was a

16 [1996] STC 68.

17 Now Inheritance Tax Act section 160.

question of fact to be established by the evidence before the tribunal of fact whether the attributes of the actual landlord would have been taken into account in the market. In the case of a deceased partner owning an interest in a tenancy which was a partnership asset it was likewise necessary to consider the actual intention of the actual surviving partner, not that of a hypothetical partner. Thus, the statutory hypothesis requires one to posit only a hypothetical purchaser and to assume a sale on the open market, even where it is improbable or even impossible, but does not require any other departure from reality.

The decision is also interesting for the attitude of the court on the *Crossman* principle, especially its "development" in *Alexander v Inland Revenue Commissioners*. Peter Gibson LJ, with whom the other Lords Justice agreed, mentioned *Crossman* in terms only as part of his statement of the uncontentious principles of valuation: "however improbable it is that there would ever be a sale of the property in the real world, for example because of restrictions attached to the property, nevertheless the sale must be treated as capable of being completed, the purchaser then holding the property subject to the same restrictions (see *IRC v Crossman* [1937] AC 26)."

Of course, the application of *Crossman* was not controversial in *Walton* in that what fell to be valued was the deceased's interest in the partnership. As this was in fact unassignable, and not merely subject to forfeiture on assignment, it was agreed "that for the purpose of assessment of tax it must be assumed that such assignment as is necessary to effect the transfer which the statute deems to have taken place has been effected, no doubt with the necessary consent".

In rejecting the argument of the Crown that one must take into account a hypothetical landlord, Peter Gibson LJ said:

> "The insuperable difficulty in Mr Neuberger's[18] path is that there is nothing in the statute to support his contention. The open market hypothesis does not require as a necessary incident of it that the landlord should be hypothetical. In my judgment the statute requires one to assume a sale but it should be assumed to take place in the real world. As was said by Lawton LJ in *Trocette Property Co Ltd v Greater London Council* (1974) 28 P&CR 408 at 420:
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>> 'It is important that this statutory world of make-believe should be kept as near as possible to reality. No assumption of any kind should be made unless provided for by statute or decided cases.'"

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18 Mr David Neuberger QC, counsel for the Revenue.

Similarly, in dealing with an alternative submission on behalf of the Crown, Peter Gibson LJ said:

> "Mr Neuberger submitted in the alternative that section 38 requires the assumption of a hypothetical landlord unless the actual landlord was a person with a policy known to the market. The freeholders in the *Trocette* case, he said, were such a person as also would be bodies like the National Trust. But to adopt a question posed by Henry LJ in the course of argument, does this mean that the well-advised family freeholders should put an advertisement in a newspaper as to the family's policy? This argument, to my mind, founders on the same rock as Mr Neuberger's primary argument, that is to say, it is not justified by the language of section 38 nor by anything said by the majority in *Trocette*. It is not necessary for the operation of the statutory hypothesis of a sale in the open market of an interest in a tenancy that the landlord should be treated as a hypothetical person, and it is a question of fact to be established by the evidence before the tribunal of fact whether the attributes of the actual landlord would be taken into account in the market."

In my respectful view, the approach of Peter Gibson LJ is absolutely correct.[19] Although *Alexander* was not cited before the Court of Appeal in *Walton*,[20] their reasoning is quite inconsistent with the result in the earlier case.

3.7 Conclusion

IRC v Crossman has been misunderstood in recent years. The decision of the Court of Appeal in *Alexander v IRC* is not binding authority because the true scope of the *Crossman* principle was not argued by the taxpayer in person. The decision of the same Court in *Walton v IRC* is much to be preferred.

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19 It is no surprise that he correctly applied the Court of Appeal decision in *Marshall v Kerr* [1993] STC 360, approved on this point by the House of Lords [1994] STC 638, as it was he who gave the lead judgment in that case.

20 It was cited before the Lands Tribunal but not mentioned in their Decision.