Taxation

Charges to stamp duty as consideration

by Janice B Shardlow

The imposition of a charge to taxation at a fixed point in time by reference to consideration inevitably causes complications where some of that consideration is contingent and accordingly may not eventually be paid. In the case of capital gains tax, a solution is found in s. 48 of the Taxation of Chargeable Gains Act 1992, which provides for an initial charge to capital gains tax on the basis that the contingent consideration will be paid, with a rebate being payable if the contingency does not actually occur.

In other words to assume the contingency will occur and assess on that basis. Due to the ‘one-off’ nature of the tax there is no prospect of a rebate should the contingency not actually occur; on the other hand it also follows that no charge can be imposed by reference to consideration which is incapable of ascertainment at that date. In the case of capital gains tax, a solution is found in s. 48 of the Taxation of Chargeable Gains Act 1992, which provides for an initial charge to capital gains tax on the basis that the contingent consideration will be paid, with a rebate being payable if the contingency does not actually occur.

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The Inland Revenue home page is a useful starting point for any research concerning taxation. The site provides access to press releases, copies of statements of practice and consultation documents.

The Inland Revenue to charge ad valorem duty on an instrument:

‘not only by reference to any sum which is conditionally payable but also by reference to any sum which is payable contingently or conditionally, that is to say on a sum which may become payable’ (Covary CC v IRC [1978] STC 151).

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In each case the lease provided that the premium the formula was expressed to be an amount equal to ‘a’ x ‘b’, where ‘a’ was a specified figure and ‘b’ was the price of 13.75% Treasury loan stock at the close of business on the 25th business day following the execution of the lease. In the case of the rent this was to be determined with reference to the net letting income of the property for the year in question, and in the case of the premium the formula was expressed to be an amount equal to ‘a’ x ‘b’, where ‘a’ was a specified figure and ‘b’ was the price of 13.75% Treasury loan stock at the close of business on the 25th business day following the execution of the lease.

The Revenue, in assessing the stamp duty to be charged under para. 3 of the head of charge ‘lease or tack’ on the leases, agreed with the appellant that no...

(1) that events will be such that a sum will be payable; and

(2) that events will be such that the sum will be equal to the stated maximum/minimum.
charge could be levied by reference to the annual rent, since it was impossible to ascertain any letting value as at the date of the lease. However they took the view that the contingency principle could be applied to the premium and assessed the premium to stamp duty by taking the closing price of the Treasury loan stock at 13 August, i.e. the last working day prior to the date of execution, 14 August, which was a Saturday.

**DETERMINATION OF PAYMENT**

At first instance Carnwath J dismissed the appeal against the assessment. He held that the contingency principle was applicable not only where the instrument in question referred to a specific sum as contingently payable, but also where the money payable contingently under the instrument was to be determined by reference to an external factor and at a date after the execution of the instrument, provided that an amount of consideration could be ascertained in the circumstances existing at the date of the instrument by applying the formula as at that date. It followed that the amount chargeable in this case was the figure produced by applying the formula in the leases at the date of their execution.

In making his decision, Carnwath J accepted the appellant's argument that the principle stated by Lord Radcliffe in *Independent Television*, was correct:

"What is necessary is that it should be possible to ascertain from the agreement that there is some specified sum agreed upon as the subject of payment which may perhaps fairly be called the prima facie sum or basic payment."

However, by applying the House of Lords decision in *Underground Electric Railways Co of London v IRC* [1906] AC 21, he found that this was possible on the facts. The *Underground* case concerned the assessment under s. 56 of the Stamp Act 1891 of a periodical payment which was to be determined by reference to a formula. This was to be paid by the purchaser of certain assets as additional consideration and was to be determined each year with reference to the profits of the purchaser in that year. The stampable document stated that such profits were to be applied first to paying a 5% dividend to shareholders on the paid-up share capital of the purchasing company at the relevant time and then, to the extent that there were profits left, to paying as further consideration for the sale, such sum as was equal to a dividend of 3% on such of the original ordinary share capital issued by the purchasing company as was, at that time, paid up. The House of Lords approved an assessment based on the minimum sum which would be payable, should there be sufficient profits at the relevant time, and on the assumption that the amount of the original issued ordinary share capital paid up at the time of the execution of the document would be the minimum amount issued and paid up at that time. Carnwath J stated:

"The importance of this case . . . is that the so called minimum sum or specified sum was ascertained not simply from the terms of the agreement but by reference to an external factor namely the amount of capital actually paid up at the date of the instrument."

In the Court of Appeal, Morritt LJ gave judgment for the respondents (Waller LJ and Sir John Balcombe concurring) and clearly rejected the appellant's contention that the contingency principle had been applied incorrectly on the basis that instead of identifying an ascertained and specified sum which the parties had agreed to pay on a contingency, the Inland Revenue had merely made an estimate of the operation of the formula by determining how it would operate immediately rather than in the future. Although accepting the fact that the immediate case concerned the charge under the heading 'lease or tack' (Stamp Act 1891, sch. 1) on the premium as a single payment, whereas the *Underground* case concerned a charge on consideration payable over a period pursuant to s. 56 of the Stamp Act 1891, Morritt LJ declined to accept attempts to distinguish the *Underground* case on the basis that:

1. the value of the relevant Treasury stock at the time of contract was not, unlike the new company's existing paid up capital in the *Underground* case, an element in the future calculation required by the formula;
2. the value of the relevant Treasury stock on any particular day was not affected by the acts of the parties to the agreement, whereas, in part at least, the amount of the company's paid up capital was.

His lordship accepted that these two differences existed, but did not feel that they were of such significance as to entitle him to refrain from applying the principle established by *Underground*. It could not be said that the value of the stock on the date of the lease was totally unconnected with its value on the valuation date, and any fluctuations were likely to be within a narrow band. In neither case was there any formula so there was no importance in the statements made in *Independent Television* and by Brightman J in *Coventry CC v IRC* that:

"If, per contra, the form of the instrument is such that a sum is payable but does not name what that sum is, or what it may be, so that the sum could in theory be any figure, subject to due quantification by reference to some formula, then there is nothing by reference to which ad valorum duty can be calculated . . . Accordingly the present issue was not for consideration."

Leave to appeal to the House of Lords was refused.

**Third contingency level**

The case takes the contingency principle one step further by applying the 'third contingency' level employed in the *Underground* case to a single payment, hence making it clear that the principle established in that case is of general application. Accordingly it would now appear appropriate for the Inland Revenue to levy a charge to stamp duty on the basis of three contingencies, i.e. by making three assumptions:

1. that events will be such that a sum will be payable;
2. that events will be such that the sum will be equal to a maximum/minimum amount;
3. that events existing at the date of execution of the instrument in question will remain the same, and accordingly the maximum/minimum can be ascertained at the date of execution of the instrument.

Whether the third assumption can be said to involve a greater leap of faith than assumptions one and two is debatable. Lord Lindley, in the *Underground* case, was happy to reject arguments that such a calculation was merely an 'accident':

"The fact that the minimum sum is payable on more contingencies than one is in my opinion quite immaterial."

The true import of the general application of this principle becomes clear when one starts to look at its application to particular factual circumstances.
It would appear therefore that, in their opinion, s. 242 will have a much more limited role than first envisaged, since the ability to make a third contingent assumption based on a reference value available should mean that it is rare that such consideration is ‘unascertainable’. Only rent fixed by reference to a completely new factor, such as the rent in L M Tenancies itself, would appear to fall within the section. It is interesting to note that, since part of the consideration being unascertainable is sufficient to ensure that s. 242 applies, should a document in the form of that used in L M Tenancies be executed today, the entire charge would be based on market value.

Earn-outs

In the context of company sales, the increasing trend to defer some, if not all, of the consideration and to make that consideration dependent, at least to some extent, on the future value of the target company – such consideration being usually referred to as an ‘earn-out’ – will ensure that what appears to be ‘unascertainable consideration’ will continue to be employed. From a capital gains tax point of view, such consideration cannot be charged to tax under s. 48 Taxation of Chargeable Gains Act 1992, since it cannot be ascertained.

However, the case of Marren (Inspector of Taxes) v Ingles [1980] 1 WLR 983 determined that a charge to tax could be imposed on the basis that the vendor was receiving a chargeable asset, namely a chose in action which was not a debt and, accordingly, a charge could be imposed on receipt of this asset and again at the point when a capital sum was derived from the asset on the realisation of the earn-out consideration. In practice this charge has rarely arisen since vendors have been able to structure their earn-out consideration so that unascertainable consideration itself constituted a chose in action, not a debt. Accordingly it did not fall within the restricted definition of stampable consideration provided by the Stamp Act 1891, namely it did not consist of cash or foreign currency, stock or marketable securities and did not fall within s. 57. The success of this argument did not appear to depend on the absence of a maximum or minimum, since its essence lay in the nature of the consideration being provided and it was accepted that such a maximum or minimum did not prevent the application of the Marren v Ingles charge. Presumably this argument will continue to be accepted and accordingly may serve to resolve the perceived tension between the interests of the vendor and the purchaser, until, that is, some enterprising person attempts to apply the L M Tenancies contingency approach within the context of capital gains tax itself.

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