

INHERITANCE TAX: VALUING THE DEAD SPOUSE'S SHARE

Francis Davey¹

Introduction

The decision of the Special Commissioner for income tax, Dr Nuala Brice, in *Arkwright v CIR*², that the value, for inheritance tax purposes, of a deceased husband's half share of the marital home, was worth less than one half, caused some surprise at the time as it was widely thought that the related property provisions of s161(4) Inheritance Act 1984 had the effect of deeming such a share to be worth exactly one half of the total value of the house. There still appears to be some confusion as to the method of valuation to be adopted in those circumstances.

The facts in *Arkwright*

Mr and Mrs Williams held their matrimonial home as tenants in common in equal shares and occupied it until the death of Mr Williams. Mr Williams died at the age of 83 of a metastatic hepatic carcinoma, less than three weeks after it had been diagnosed. At the time of his death, his widow, Mrs Williams, was aged 79 and in good health.

By his will, Mr Williams left a life interest in his share of the matrimonial home to Mrs Williams, with the remainder to his daughters. By a deed of variation, the effect of the will was changed so that his share of the home vested immediately in his daughters.

The Commissioners of Inland Revenue determined that the value of Mr Williams's

¹ Francis Davey MA (Cantab), Bridewell Chambers, 2 Bridewell Place, London EC4V 6AP, Tel: 020 7797 8800; Fax: 020 7797 8801; Email: clerks@bridewell.law.co.uk; DX: LDE 383

² [2003] SpC 392

interest was one half of the value of the house. His personal representatives then appealed to a Special Commissioner.

The personal representatives' argument was that prior to the death of Mr Williams his interest was less valuable than that of Mrs Williams because she had a right of occupation under the Trusts of Land and Appointment of Trustees Act 1996. The Inland Revenue relied on the deeming provisions of s161(4) and also argued that s171(1) of the Inheritance Tax Act 1984 applied. This meant that the imminence of Mr Williams's death should not be taken into account in computing the values of the two shares.

Legal Argument

Section 161(4) IHTA 1984 provides:

- (4) For the purposes of subsection (3) above the proportion which the value of a smaller number of shares of any class bears to the value of a greater number shall be taken to be that which the smaller number bears to the greater; and similarly with stock, debentures and units of any other description of property.

The applicants argued that s161(4) did not apply, for two reasons: (1) an incorporeal share of land could not be described as constituting "units of any other description of property"; and (2) s161(4) did not apply where the two shares were equal. Dr Brice accepted both arguments, which means that s161(4) ought not to apply even to an unequal share of property.

It is this aspect of the case which has caused the most surprise, since it would appear to conflict with the previous understanding of the Inland Revenue and most tax practitioners, although on a proper construction of the statute it would appear to be right.

The Inland Revenue had also argued that s171(2) IHTA 1984 disapplied s171(1). S171(2) IHTA 1984 had the effect that changes occurring by reason of the death of Mr Williams were to be regarded, but it is clear that the excepting clause in s171(2) applies only to the situation where an interest passes on survivorship, whereas the interest of Mr Williams had passed by will and so that part of the Revenue's case was bound to fail. The Inland Revenue did not appeal either decision of Dr Brice on the meaning of the provisions of the Inheritance Tax Act.

The valuation of the share

Dr Brice then considered the manner in which the value of Mr Williams's share should be assessed. The starting point provided by section 160 IHTA 1984, is the price the property would fetch on the open market, that is a sale is assumed between a willing purchaser and a willing vendor immediately prior to the death of Mr Williams (*Lynall v IRC* [1972] AC 680).

The next step is to consider whether the formula in s161(3) IHTA 1984 is applicable. Section 161 IHTA 1984 provides:

“161 Related property

- (1) Where the value of any property comprised in a person's estate would be less than the appropriate proportion of the value of the aggregate of that and any related property, it shall be the appropriate proportion of the value of that aggregate.
- (2) For the purposes of this section, property is related to the property comprised in a person's estate if-
 - (a) it is comprised in the estate of his spouse;
- (3) The appropriate proportion of the value of the aggregate mentioned in subsection (1) above is such portion thereof as would be attributable to the value of the first mentioned property if the value of that aggregate were equal to the sum of the values of that and any related property, the value of each property being determined as if it did not form part of that aggregate.

The trigger for the application of s161(3) is whether the value of Mr Williams's share would be less than the “appropriate portion” of the value of the house if it were valued separately. The “appropriate portion” requires an assessment of the value of both the shares of Mr and Mrs Williams separately.

appropriate proportion = value of Mr W's share / (value of Mr W's share + value of Mrs W's share)

In other words, s161(3) will always be triggered if the shares of Mr Williams and Mrs Williams would be worth less sold separately on the open market than they would be if sold together.

The effect of Mr Williams's death

Section 171 IHTA 1984 states:

“171 Changes occurring on death

- (1) In determining the value of a person's estate immediately before his death changes in the value of his estate which have occurred by reason of the death and fall within subsection (2) below shall be taken into account as if they had occurred before the death.
- (2) A change falls within this subsection if it is an addition to the property comprised in the estate or an increase or decrease of the value of any property so comprised ...”

At first sight it would seem that the death of Mr Williams ought to have little effect on a hypothetical purchaser of his share in the property, since, having sold his share immediately prior to his death, the subsequent demise of Mr Williams ought to have no effect. It would seem that this is incorrect.

Recall that section 161(3) requires a valuation of both Mr and Mrs Williams's shares as if they were sold separately. After the death of Mr Williams, a purchaser of his wife's share would no longer take subject to his right of occupation, precarious though that might have been given his state of health. It is quite plausible to assume that with the death of Mr Williams a certainty and not merely a likelihood, the value of his wife's share would increase, decreasing, by the application of s161(1), the value of his share.

If this is the case, s171 is engaged and value of Mr Williams's share is to be assessed as if he had already died.

Dr Brice's conclusion on valuation

Dr Brice accepted the personal representatives' argument that a willing purchaser on the open market would take into account the fact that Mrs Williams had a right of occupation under the Trustees of Land and Appointment of Trustees Act 1996. It would be unlikely for a court to make an order for sale of the property, given that it was Mrs Williams's only home, and as a result the purchaser would not be able to realise the value of their asset so long as Mrs Williams continued to occupy the property. The value of her husband's share would be discounted accordingly and be worth less than half the value of the entire house.

Dr Brice also concluded that the death of Mr Williams would decrease the value of

his share of the property, and so, by operation of s171 IHTA 1984, his death would have to be disregarded for valuation purposes.

The High Court overturned Dr Brice's conclusions on this point. While her assumptions concerning the valuation of Mr Williams's share were entirely reasonable, s222 IHTA 1984 requires questions as to the valuation of land to be referred to the Lands Tribunal. There was a strict demarcation between the role of the Special Commissioners, whose responsibility was to deal with all questions of law which arose, and that of the Lands Tribunal, which carried out any valuation of land that was required. No criticism was made of Dr Brice's decision as to the correct process that should be applied in assessing the value of a deceased spouse's share.

Comment

Prior to the decision in *Arkwright* it was assumed that s161(4) IHTA 1984 applied to a half share in property such as that of Mr Williams. This was a commonplace situation and it was straightforward for tax practitioners to return the value on an Inland Revenue account at death. *Arkwright* has complicated matters since a valuation exercise is now required, not merely of the home as a whole, but of the half share.

One area that has created much confusion is the way in which the value of that share should be assessed and, in particular, how that is affected by the relative ages and possibly state of health of the married couple.

If the relative life expectancy of the two couples makes any difference to the valuation of the couple's individual shares, as it might, then the death of one spouse is almost certain, by converting a possibility into a certainty, to decrease the value of his share as explained above. Section 171 would then be engaged and the valuation exercise would have to be carried out on the basis that the deceased spouse had already died.

This means that the age of the deceased at death, or his state of health, is very unlikely to have any bearing on the valuation of his share. This is contrary to an approach, suggested by many commentators, which involves taking into account the relative ages of the couple, for example by consulting actuarial tables in order to compare their relative life expectancy (see for example *How much is a half?* Taxation 14 October 2004, page 41).

It is also important to ensure that, when considering the question of valuation, the trigger conditions in s161(1) and s171(1) are examined. The High Court is very clear that neither provision will apply as a matter of law to the valuation of a deceased spouse's share; but only if, as a matter of fact, they are found to apply.

Such a finding cannot be made by a Special Commissioner but only by the Lands Tribunal.

A further difficulty presented by *Arkwright* is the extremely theoretical nature of the enquiry that it forces on the Lands Tribunal. There is no open market in part shares of family homes, and so it is very difficult to assess what effect a widow's or widower's right of occupation will have on the value of their deceased spouse's share.

One approach, the "income method", is to attempt to capitalise the expected income that a purchaser might expect to receive from his half, for example as a charge from the living spouse for their occupation of the purchaser's share. Such an approach has been criticised by the Lands Tribunal (see for example *Re Charkham 6th March 1997*) which as a matter of practice appears to prefer the "entirety method" which involves applying a percentage reduction to the value of the entirety. The reduction attempts, in an approximate way, to encompass all the factors making the ownership of a part share unattractive, in particular the considerable uncertainty as to when the value of the share can be realised through a sale.

Example

A married couple A and B own half shares in the matrimonial home which is valued as a whole at £360,000. On the death of A at age 45, B is aged 60.

Suppose the Lands Tribunal were to find that a willing purchaser on the open market would discount the value of B's share by 10%, to account for the inconvenience of owning a half share, and A's share by 25%, to account for the further inconvenience of B's right of occupation; and assuming that the Lands Tribunal found that s171 applied, this would give:

value of A's share	£135,000
value of B's share	£162,000

Applying s161 IHTA, the "appropriate portion", which is the fraction of the value of the house assigned to A's share for inheritance tax purposes, is:

$$£135,000 / (£162,000 + £135,000) = 45\frac{5}{11}\%$$

A's share would therefore be worth £163,636.34, which illustrates the rather peculiar effect of s161 in these circumstances.

Conclusion

It has been suggested that HM Revenue and Customs may seek amending legislation that would give effect to their prior understanding of the law. If they do not, clear guidance will be needed on how to go about valuing a deceased spouse's half share on an open market that does not exist.