PARTIALLY EXEMPT ESTATES AND RELIEVED PROPERTY

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1 Scope of the Article

On the death of a person, tax is to be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death.[2] Questions as to taxability can arise where the deemed value of a person's estate for inheritance tax purposes immediately before his death is not equal to its real value at that time and part of the transfer of value deemed on be made on his death is exempt. The difficulty is usually encountered in the context of business property and agricultural property relief. In each case, where the whole or part of the value transferred by a transfer of value is attributable to the value of specified property, the whole or part of that value transferred is reduced by either 50% or 100%. Yet while there is a reduction in the value transferred, there is no reduction in the deemed value of the transferor's estate immediately before the transfer.[3]

It was generally considered before the amendments made to the Inheritance Tax Act 1984 by Finance Act 1986 that the rules for attributing relief to different gifts under a will worked in an anomalous and capricious way, sometimes to the detriment of the taxpayer and sometimes to his benefit, especially where he had invested in sound advice. I suggest in this article that the amendments are defective and that there is still considerable scope for tax planning by careful or even imaginative will drafting.

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[2] Inheritance Tax Act 1984 section 4(1).

[3] Inheritance Tax Act 1984 section 104(1) and section 116(1).

Let us consider a classic example which neatly illustrates the difficulty. The estate of a testator consists only of agricultural property worth in reality £1m but which qualifies for 50% agricultural relief. By his will he makes a specific gift of a one-half share in the land to his widow and bequeaths the residue of his estate to his son.

2 The Pre-1986 Law

The relevant law is contained in Inheritance Tax Act 1984 Part II, Chapter III, Allocation of Exemptions, comprising sections 36-42. Prior to the insertion, by Finance Act 1986, of section 39A (operation of sections 38 and 39 in case of business or agricultural relief), it was generally considered by both the Revenue Bar and the Capital Taxes Office that the provisions worked in an arbitrary and capricious way which could result in an estate qualifying for double relief or in losing the benefit of its reliefs altogether! In *Russell v IRC*[4] Knox J decided, contrary to the contentions of the Revenue, that the old provisions did in fact work in a sensible way. It is arguable to what extent the decision is of any relevance to the current law. It represented the high water mark of judicial "amendment" of defective legislation. It is questionable to what extent it would have been sustained on appeal.

The learned judge also decided another point, which was totally contrary to what I believe was the universal and firm opinion of the Revenue Bar, namely that one could in principle have successive variations of the dispositions of the estate of a deceased person in respect of which an election could be made pursuant to Inheritance Tax Act 1984 section 142 (alteration of dispositions taking effect on death), provided that they were all made within the two year period. His Lordship held that a variation of a variation could not fall within section 142. The result of what were in my opinion twin errors was paradoxical. While the taxpayers won the case, the Revenue had one important point of law, namely that a variation of a variation could not fall within section 142, decided in their favour, and they must have been most happy to have been told that their contention on the effects of Part II, Chapter III, was wrong; for if Knox J were right, what the Revenue perceived as an important loophole in the capital transfer tax legislation had never existed. It was therefore not surprising that neither party appealed the decision.

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4 [1988] STC 195.

3 The Operation of the Statute

3.1 Scope of Chapter III.

Section 36(1) provides:

> "Where any one or more of sections 18, 23 to 27 and 30 above apply in relation to a transfer of value but the transfer is not wholly exempt:
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> (a) any question as to the extent to which it is exempt or, where it is exempt up to a limit, how an excess over the limit is to be attributed to the gifts concerned shall be determined in accordance with sections 37 to 40 below; and
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> (b) section 41 below shall have effect as respects the burden of tax."

Section 18 confers the most important exemption of all, namely that applicable to most transfers between spouses. A transfer of value is in general an exempt transfer to the extent that the value transferred is attributable to property which becomes comprised in the estate of the transferor's spouse or, so far as the value transferred is not so attributable, to the extent that that estate is increased.[5] Section 23 confers the exemption for charities; transfers of value are exempt to the extent that the values transferred by them are attributable to property which is given to charities, i.e. which either becomes the property of charities or is held on trust for charitable purposes only.[6]

The core section is section 38, attribution of value to specific gifts. "Specific gift" is defined to mean "any gift other than a gift of residue or a share in residue". "Gift" is defined to mean, in relation to any transfer of value, "the benefit of any disposition or rule of law by which, on the making of the transfer, any property becomes...the property of any person or applicable for any purpose", and "given" is to be construed accordingly.[7]

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5 Section 18(1).

6 Section 21(1) and (6).

7 The definitions are contained in section 42(1).

Section 38(1) provides:

> "Such part of the value transferred shall be attributable to specific gifts as corresponds to the value of the gifts."[8]

Section 39 provides that such part only of the value transferred shall be attributed to gifts of residue or shares in residue as it not attributed under section 38 to specific gifts.

Before the addition of section 39A by Finance Act 1986, the Act contained no further indication as to how one attributed the total value transferred on death, i.e. the deemed value of the estate of the deceased for inheritance tax purposes immediately before his death, to different gifts. The general view was that one attributed such part of the value transferred to specific gifts as was equal to the value of those gifts. Thus, in the example, in section 1, as the gift to the widow was in fact worth £500,000, one attributed to it £500,000 of the value transferred. Given that this was the entire value transferred on the death of the testator, as the value transferred referrable to the agricultural property in fact worth £1m was reduced by 50% agricultural relief to £500,000, this left no value to be attributed to the residuary gift. Hence, the whole of the value transferred on the death of the testator was exempt. Conversely, had the son been the recipient of the specific gift and the widow the residuary legatee, the whole of the £500,000 value transferred on death would have been attributed to the son and would have been chargeable and the agricultural relief would have been completely wasted, being in effect entirely attributed to the already exempt gift in favour of the widow.

3.2 *Russell v IRC*

Mr Justice Knox decided in *Russell v IRC*[9] that "in relation to a gift in specie of an asset which is the subject of business relief the expression 'the value of the gift' is capable of bearing the meaning 'the value after business relief where appropriate has been given', and should in the context be so construed."

In fact, the relevant gifts in that case were not of business property as such, but consisted of a direction to the testator's executors to raise out of the business property four legacies payable to his daughters. The Revenue conceded that a gift

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8 To the extent that a gift is (a) not a gift with respect to which the transfer is exempt or is outside the limit up to which the transfer is exempt, and (b) does not bear its own tax, the amount corresponding to the value of the gifts is to be taken to be the amount arrived at in accordance with section 38(3) to (5). Subsection (6) deals with liabilities.

9 [1988] STC 195.

of a share of business property would be treated in just the same way as a gift of the whole of business property. On the other hand, it was not suggested on behalf of the taxpayer that an ordinary pecuniary legacy which, due to the composition of the estate, would be likely or even bound to be payable out of the proceeds of sale of such business assets would qualify for any reduction in value on that account. Knox J decided that where there is a gift which as a matter of construction of the relevant instrument can *only* be satisfied by resort to an identified asset which is the subject of business relief, the basis of valuation for the purposes of what is now Chapter III should be the same as that applicable to a gift of that asset or of a share of that asset in specie. He saw no sufficient reason in this context to treat a subdivision by reference to cash value differently from a subdivision by reference to a fraction.

His Lordship remarked that the gifts under consideration were not true demonstrative legacies, since the latter are payable out of other assets if the specific fund designated as the source for payment proves insufficient. The only possible source for the payment of the legacies was the testator's business property. He left open what the position would be if the legacies were demonstrative.

4 Inheritance Tax Act Section 39A

4.1 The Statute

That decision was made by reference to events occurring before the insertion into Chapter III of section 39A, which provides:

> "(1) Where any part of the value transferred by a transfer of value is attributable to -
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> (a) the value of relevant business property; or
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> (b) the agricultural value of agricultural property,
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> then, for the purpose of attributing the value transferred (as reduced in accordance with section 104[10] or 116[11] below), to specific gifts and gifts of residue or shares of residue, sections 38 and 39 above shall have effect subject to the following provisions of this section.

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[10] Business property relief.

[11] Agricultural property relief.

> (2) The value of any specific gift of relevant business property or agricultural property shall be taken to be their value as reduced in accordance with section 104 or 116 below."

Section 39A(3) provides that the value of any specific gifts not falling within sub-section (2) are to be taken to be "the appropriate fraction" of their value. "The appropriate fraction" is defined, by section 39A(4), to mean:

> "a fraction of which:
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> > (a) the numerator is the difference between the value transferred and the value, reduced as mentioned in subsection (2) above, of any gifts falling within that-sub-section, and
> >
> > (b) the denominator is the difference between the unreduced value transferred and the value, before the reduction mentioned in sub-section (2) above, of any gifts falling within that subsection;
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> and in paragraph (b) above "the unreduced value transferred" means the amount which would be the value transferred by the transfer but for the reduction required by sections 104 and 116 below."

4.2 The Technical Defects

The *aim* of the draftsman is clear enough. Where there are specific gifts of relevant business property or agricultural property, one should attribute such part of the value transferred on death to those gifts as corresponds to their value as reduced by the relevant relief. Hence, the relief attributable to such gifts is, quite properly, fully attributed to them. To the extent, however, that property qualifying for relief is not the subject matter of specific gifts, then the relief is spread rateably over the rest of the estate.

Given that section 39A was intend to cure defective drafting, section 39A(2) is ironically itself defectively drafted! It is assumed that the effect of relevant business property or agricultural property relief is to reduce the value of the relevant business property or agricultural property in question. Had that been the case, there would have been no need of section 39A! Instead, what is reduced is the value transferred by a transfer of value which is attributable to the value of any relevant business property or agricultural property. The value of the property is not itself deemed to be reduced. Nevertheless, in 1997 it is very likely that the court would take a robust construction of subsection (2) and would be loath to hold that it had missed its mark.

What of the case where the value transferred on death is reduced wholly by 100% business and/or agricultural property relief, a situation not capable of occurring in 1986 when section 39A was added? In that case, the opening words of section 39A(1) are not satisfied, as none of the value transferred is attributable to such property! Oddly enough, if there is even a tiny amount of property qualifying for 50% relief, then the section will apply in terms, even as regards property qualifying for 100% relief!

The draftsman also appears to have forgotten that the charge on death is based on the entire value of the deceased's estate, viewed as a whole; see *Commissioners of Inland Revenue v Gray*.[12] One is not normally called upon to identify the value of parts of that estate which may be separately devised or bequeathed. For example, a testator may have a 100% shareholding in a private company. He may make bequests of one quarter of the shares to each of his sons. Now the value of the 25% holdings is totally irrelevant. The valuation of the property for the purposes of calculating the value transferred (before any reliefs are given) is based on the value of the 100% holding. Again, I consider that in 1997 the courts would adopt a robust construction and hold that the value of a specific gift was not its value taken in isolation but such part of the value of the entire estate as was on a just apportionment attributable to it. This might well result, as in the example, in the value of the gift for the purposes of section 39A(2) being greater than its real value.

4.3 Crudeness of the Subsection

Insofar as section 39A does work as it was intended to, the provision for the attribution of value to specific gifts of relieved property is eminently fair and sensible. Beyond that point, however, the section is intended to produce but rough justice, in that relief not attributed to such property is spread rateably over the rest of the estate. Where, for example, there is a specific gift of non-relieved property, one would expect none of the relief to be attributed to it. Such is not the case, which in all justice it clearly should. Nor is there to be any investigation whether pecuniary legacies are in fact paid out of relieved property, even when they are demonstrative, are primarily to be paid out of the relieved property and such property is sufficient for their payment. Even more surprisingly, the draftsman has gone even further and added section 39A(6):

> "For the purposes of this section the value of a specific gift of relevant business property or agricultural property does not include the value of any other gift payable out of that property; and that other gift shall not itself

[12] [1994] STC 360.

be treated as a specific gift of relevant business property or agricultural property."

This is the most extraordinary provision. Suppose a testator to leave agricultural property worth £1,000,000 qualifying for 100% relief, plus property worth £20,000 qualifying for 50% business relief, plus investments worth £1,000,000 qualifying for no relief. He wishes to leave the agricultural property to his wife and the rest of his estate to his son. If he leaves the agricultural property to his wife by a specific gift and the residue to his son, the agricultural relief will be completely wasted, as it will be attributed to the gift to the wife which will be in any case exempt. If, on the other hand, he leaves his agricultural property to his wife charged with payment thereout of £990,000 to his son, and then leaves the residue to his wife, what will the consequences be? Section 39A(6) makes it clear that the gift to the son is not a gift of agricultural property and that the value of the specific gift to the wife is only £10,000. Hence, the remaining agricultural relief of £990,000, together with the business property relief of £10,000, total £1,000,000, is spread rateably over the gift of £990,000 to the son and the residue worth £1,020,000. Thus, agricultural relief of £492,537 is attributed to the gift to the son! And there is nothing to stop the wife from selling the investments to pay the charge or, indeed, in transferring them to him *in specie* in satisfaction of his claim. In this case, the anomaly has worked to the advantage of the taxpayer, but it could as easily work to the advantage of the Revenue.

It is a moot point how far this subsection spreads its absurdity. The learned authors of *Dymond's Capital Taxes* seem to consider, as do I, that its effect is limited to a gift to A charged with a gift to B, but I have seen the view expressed that its ambit might be much greater. Now, a gift of agricultural property to A and B as tenants in common in equal[13] shares must surely be a specific gift of that property, outside the scope of section 39A(6). The fact that they will hold it on trust for sale and on trust to pay one-half of the net proceeds of sale to each of them can surely make no difference. Nor can the fact that it is given to X and Y upon trust for them as tenants in common in equal shares absolutely, which involves[14] a mandatory trust for sale. Suppose that the testator expressly directs his trustees to sell the property and divide the proceed between them. That again, is indistinguishable from the preceding cases. In none of these cases is one gift payable out of another *gift*.

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[13] It should make no difference that the shares are not equal or that there are more than two tenants in common.

[14] At least prior to 1st January 1997.

4.4 Planning Opportunities

If I am right, then it follows that an enormous amount can be done by clever drafting to direct the incidence of reliefs towards chargeable, and away from exempt, gifts. Suppose, for example, a testator's estate consists largely of unrelieved property, such as his home and quoted shares, but he has a holding of shares in a private company which qualifies for 100% business relief. He wishes to give the bulk of his estate to his wife, yet wishes also to give some pecuniary legacies. If his will is drafted in the normal way, the relief will be spread rateably over the whole of his estate and will thus be in part wasted. If he gifts the private shareholding on trust for the non-exempt beneficiaries, none of the value transferred on his death will be attributed to that gift. Of course, shares may go up or down in value. There are ways of ensuring that the non-exempt beneficiaries finish up with more or less as much cash as the testator intends. These can involve making the quantum of shares gifted depend on their value at the date of death or fixing the relative proportions the beneficiaries receive by reference to the value of the entire holding at that time. Provision can be made for a supplementary pecuniary legacy should the value of the shares not be enough to give each non-exempt beneficiary as much as is desired. Conversely, a fraction of the gift can be given to the residuary legatee if the shares are likely to be worth too much. As this is an extremely technical area, a skilled draftsman will be needed.