INHERITANCE TAX - LIFETIME TRANSFERS AND BUSINESS PROPERTY

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The Finance Act 1992 increased to 100% the reduction in the value transferred attributable to the main categories of property qualifying for relief as business property for inheritance tax purposes (interests in a business, shareholdings carrying control, and shares in unquoted trading companies carrying more than 25% of voting power). Other categories of business property qualifying for relief now enjoy a reduction in the value transferred of 50 per cent. As a reaction to this change it has become unfashionable to make lifetime gifts of such property. If property qualifies for a reduction in the chargeable value transferred attributable thereto of 100% the owner of such property will lose nothing by retaining such property in his estate and gifting it by will to his children or, say, to the trustees of a discretionary trust established for the benefit of a class including his spouse and children.

Retention of the property may have a positive advantage. The death of the owner will be the occasion for a deemed acquisition of the property for the purposes of capital gains tax for a consideration equal to market value (s.62 Taxation of Chargeable Gains Tax Act 1992. There is provision (s.165 TCGA) for the "hold-over" of the gains accruing on lifetime gifts of most if not all of the categories of business property for which inheritance tax relief is available. But the gains held over will in many cases be brought within the charge to capital gains tax on subsequent disposals by the donees. So, except in those cases where the whole gain accruing on a lifetime disposal of business property escapes treatment as a chargeable gain under the provisions of ss.163 and 164 TCGA ("retirement relief"), conventional wisdom has it that the best advice to the owners of business property qualifying for the full reduction of 100% in the value transferred is to retain such property until death.[2]

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2 Business property relief in its present form was comprehensively reviewed by Alasdair Benzie in PTPR Vol 1 p.205. This article is concerned only with the effect of the relief in the case of lifetime transfers - or events treated as such.

Reasons for Lifetime Gifts of Business Property

There remain, however, a wide variety of circumstance in which, whether for reasons of practicality or necessity, it may not be possible or advisable to follow the course which convention dictates. A good illustration is itself provided by the most typical case: that of the successful entrepreneur who alone or through the combined shareholdings of his wife and himself has voting control of a successful trading company. In most cases the continuing success of the company will depend on the active commitment of capable and enterprising managers who must have the incentive to improve and develop the business. The successful controller on whose abilities and industry the fortunes of the company were founded is increasingly less likely to provide the qualities for continuing success in his old age. Younger men (or women) will have to be found. Such persons will usually look for something more than salary as a stake in the business the continuing success of which will largely depend on their abilities and willingness to apply the same. Where they are found from outside the family circle of the founder of the company it may be possible to provide them with sufficient incentive by the transfer of small parcels of shares or options or share purchase schemes which would not have the effect of depriving the founder of control or at least of shares carrying more than 25% of the votes.[3]

That is unlikely, however, to be the case where the management expertise is to be provided by members of the entrepreneur founder's family circle. The sons and daughters of the ageing controllers of the company on whom it must depend for its future will frequently have spent a large part of their working lives in the business - in many cases for rewards which might be considered inadequate. It is not reasonable to expect them to continue to work in the business as managers indefinitely in the expectation that a controlling shareholder or business proprietor (usually their father) will adhere to his expressed testamentary intention of bequeathing his holding to those of his children who are involved in the active management of the business. The children of the founder of the business will prefer the certainty which a lifetime gift of shares or of an interest in an unincorporated business confers to the uncertainties (however improbable they may appear) attendant on the testamentary intentions of their parent.

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[3] In most cases gifts of shares to employees or on trust for employees not being members of the transferor's family are likely to escape treatment as transfers of value under either s.10 IHTA or s.28 IHTA. The availability and scope of the wide variety of Inland Revenue approved share option and incentive schemes and ESOP's are way outside the scope of this article.

Lifetime gifts of the whole or of part of a controlling holding of shares or an interest in the business to the children who are to have the management of the business, or which are otherwise intended to satisfy or placate them (such as generation-skipping gifts to trustees for the grandchildren of the founder of the business or controlling shareholder), more usually took the form either of an outright gift of shares or an interest in the business or the settlement of the gifted property on "accumulation and maintenance" trusts satisfying the conditions found in s.71 of the Inheritance Tax Act 1984 (IHTA). Such transfers of value are, of course, potentially exempt transfers ("PETs") which will not become chargeable for the purposes of inheritance tax unless the donor dies within 7 years. The founder (or controlling shareholder) could confer on his children who, as managers, are to be responsible for the continuing success of the company or business a measure of certainty as to their ultimate inheritance by settling the shares on himself for life with remainder on trust for the children concerned. That course would avoid the making of a PET since the property would remain comprised in the settlor's "estate". But it would carry with it the disadvantage that any gain "heldover" at the time of the gift into settlement (i.e, the gain not exempted by "retirement relief") would become chargeable on the death of the transferor/life tenant under s.74 TCGA. In reality this course was and is no improvement on a PET. The adverse consequences (the loss of relief) resulting from the giving up of ownership of the property qualifying for relief would be as likely to affect business property remaining in the settlor's estate as it would to PETs to which s.113A IHTA applied.

Now, with the introduction of the full 100% reduction for the main classes of business property, gifts of such property into discretionary settlements (i.e, those conferring on the trustee wide powers of appointment and a discretion over income)[4] are likely to be of greater practical utility.

One other effect of the advancing years of the controlling shareholder or of the proprietor of a business or interest therein is that larger proportions of the resources of the company or business are likely to be expended in the purchase of income-producing investments requiring less time and management attention than assets purchased for expansion of the trade on which the fortunes of the company or business enterprise were founded. These investments will be "excepted assets" the existence of which will result in a partial loss of business property relief on a transfer of value attributable to the value of the shares or

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4 "Discretionary settlement" is used throughout to distinguish such settlements from interest in possession settlements, and accumulation and maintenance trusts within s.71 IHTA.

business concerned (s.112 IHTA). It is possible to minimise the effect of "excepted assets" on the loss of relief either by acquiring assets for use in the business in place of the excepted assets or by charging the excepted assets to secure indebtedness incurred in the acquisition of other assets for use in the business. But it is difficult to plan ahead in this manner - in particular to contrive to bring about a state of affairs on the death of the controlling shareholder or owner of the business whereby the value of any excepted assets will be kept to a minimum. The adverse impact of the acquisition of excepted assets is the most commonly overlooked drawback flowing from the continued ownership of property otherwise qualifying for relief at the death.

There is here a second advantage in the making of a lifetime gift of the whole or part of property qualifying for relief as business property by way of lifetime gifts - whether by way of a PET or by way of gift to the trustees of a discretionary settlement. The controlling shareholder, the holder of shares carrying more than 25% of the votes or the proprietor of or partner in the business can plan the making of his gifts so as to ensure that they are made at a time when there are no excepted assets of any value whose existence would serve to reduce the relief available should the gift be or become chargeable. The availability of relief would not then be dependant on the uncertain position likely to prevail at his death. Planning in such cases can be short-term. The replacement of excepted assets by assets which are not within that description (such as plant or machinery) may be made at any time before the relevant transfer of value. There is no requirement that the new (non-excepted) assets should be owned for the 2 year period specified by s.106 IHTA as the minimum period for ownership of the interest in the business or shares qualifying for relief.

The most compelling reason for making a lifetime gift of business property qualifying for relief now is political. There is a perception that the increased level of relief introduced by FA 1992 may be too generous to the owners of such property. It is more than likely that a future government may reduce the level of relief available on future transfers of value.

The Disadvantages of a Lifetime Gift

Capital Gains Tax

What then are the disadvantages of a PET or other lifetime gift of property qualifying for business property relief? One - that is, the inability to roll up the chargeable gains accruing in respect of such property to the date of death of the donor - has already been mentioned. This disadvantage should not be overstated. Retirement relief may itself take out of the charge all or most of any chargeable gains otherwise accruing on the disposal by way of life time gift. The residue of any gain held over under the provisions of s.165 TCGA may become chargeable on subsequent disposals. But the held-over gains will themselves escape the charge if the business assets continue to be held by the transferee at his death, except where the transferee is an interest in possession beneficiary of the gifted property. Furthermore, leaving aside sales to outside parties (e.g., following a stock exchange flotation), the wide variety of "roll-over" provisions (e.g, s.162 TCGA - on transfer of business to a company in exchange for shares, s.135 TCGA - exchange of shares in one company for shares in another, s.192 TCGA - relief on demerger) will in many cases operate to postpone the day on which tax comes to be paid on the held-over gain into the distant future.

S.113A IHTA - The Mischief

The draftsman of the FA 1986, which transformed capital transfer tax into inheritance tax and brought with it the exemption conferred on PETs made more than 7 years prior to the death of the donor, was minded to ensure that donors and donees should not take undue advantage of Parliament's generosity in creating the exemption conferred on PETs. To frustrate donors minded to have their cake and eat it some of the more ancient weapons in the estate duty armoury (the provisions relating to "benefits reserved") were brought out and removed from mothballs. A further problem confronting the draftsman was that in determining the value transferred by a PET in the event of its becoming chargeable (i.e, on the death of the donor within the 7 year period) the value transferred would have to be determined by reference to the nature and value of the property at the time of the gift. This was not so for estate duty purposes (compare s.38 FA 1957). If nothing was to be done, a recipient donee of property comprised in a PET which qualified for relief as business property or agricultural property at the time of the gift could, immediately following the gift, sell the gifted property. On the subsequent death of the donor within the 7 year period, relief would then be available so as to reduce the chargeable value transferred by the requisite percentage applicable to the property at the date of gift notwithstanding that, if the donor had himself retained and thereafter sold the property, relief would not have been accorded to the proceeds on his subsequent death. This was the mischief at which ss.113A and 124A of the IHTA were primarily aimed. I state "primarily" because it is notorious that these provisions are fully capable of applying in a wide variety of cases, far removed from an outright sale, involving loss of "ownership" of the gifted property by the transferee.

S.113A - the Effect

The tenor of ss.113A and 124A (the latter containing provisions relating to agricultural property) and the corresponding relieving provisions of s.113B and 124B dealing with replacement assets is well known. In the case of business property the provisions operate to prevent a claim to business property relief in respect of the value transferred by a PET on its becoming chargeable on the death of the donor within the 7 year period unless the donee has retained the property and that property would in its turn qualify for relief as business property in the hands of the donee (subject to the disapplication of the 2 year ownership test found in s.106 IHTA). The provisions have like effect in cases where the business property was the subject of a lifetime chargeable transfer within the 7 years ended with the death of the donor (i.e, where the "transferees" (the donee) are a company or the trustees of a discretionary settlement) with one major distinction. If a PET becomes chargeable the value transferred is aggregated with the other chargeable transfers made by the deceased (e.g., on death) in arriving at the chargeable value transferred. But where, following a chargeable transfer of business property, there is a sale of the property concerned by the company or the trustees of a discretionary settlement, or any other event which results in their ceasing to be the "owners" of the property (say, an appointment on interest in possession trusts), that event will not affect the cumulative chargeable value transferred on the death of the transferor/settlor within the 7 year period. That value will continue to be calculated on the basis that the relevant business property qualified for relief notwithstanding the sale or other disposition. Instead, the sale or other disposition resulting in the company or such trustees ceasing to be "owners" will result in the chargeable value transferred on this gift being computed without regard to the relief, but only for the purposes of re-calculating the tax payable in respect of this value transferred by the gift.[5]

Example:

Brown settles a holding of shares carrying 30% of the votes (market value, say £200,000) in his trading company Widgets Ltd on discretionary trusts. This

[5] See s.113A(2). Loss of relief will not therefore affect the tax payable on death. It is a more open question as to whether subs.(2) operates to prevent the cumulation of the chargeable lifetime transfer of value as recomputed with other chargeable lifetime transfers whose value has under these provisions been increased following a disposal of the business property the subject of these other transfers. See further below.

is Brown's direct chargeable transfer. Provided the conditions in ss.105 and 106 IHTA as to length of ownership and the nature of the business are satisfied, and there are no "excepted assets", the value transferred by this chargeable transfer will be reduced by 100% to nil (to determine the tax charged at the lifetime rate of 20 per cent). Two years after the gifts Widgets Ltd goes into liquidation. One year after that event Brown dies. The value transferred on Brown's death will be computed on the basis that the chargeable value transferred on the gift into settlement is nil. But the trustees will be treated (assuming that the gift was the first chargeable transfer made by Brown) as if the chargeable value transferred was £200,000 and tax of £20,000 [40% of (£200,000 - £150,000 nil rated] will be payable (s.7(4) IHTA).

If Brown had made no other lifetime chargeable transfers and died leaving an estate of £150,000 (all being subject to a chargeable transfer on death) and the gift had been in the form of a PET (say, to the trustees of an interest in possession settlement) his estate would have borne tax of £60,000 which would have been in addition to the tax borne by the donee trustees. There would have been no charge if the liquidation of Widgets Ltd could have been avoided.

Given that the 40% rate is potentially applicable to PETs becoming chargeable on the death of the transferor within the 7 year period, the use of the discretionary settlement as a vehicle for holding business property is not to be accounted a drawback. Where the property which was the subject of the lifetime gift did not qualify for business (or agricultural) property relief it makes little difference to the inheritance tax chargeable on death of the donor within the 7 year period whether the lifetime gift was in the form of a PET or was a chargeable transfer at the time it was made. But if the gift is of property qualifying for relief there is a clear advantage in settling it on discretionary trusts - at least in those cases where the nature of the property qualifies it for the full 100% reduction. This will be so in all cases where an early sale or other disposition occasioning loss of ownership to the trustees is in contemplation.

It is not entirely clear whether the words in s.113A(2) "the additional tax chargeable by reason of the death shall be calculated as if the value transferred on the death had not been so reduced" mean that the chargeable value transferred on the gift to the trustees of the discretionary settlement or company is to be recomputed only for the purposes of calculating the additional tax payable in respect of that chargeable transfer, or whether earlier chargeable transfers of value which have also been recomputed under s.113A(2) may also be taken into account. In my view the recomputation is only for the purposes of calculating the tax payable on the specific lifetime chargeable transfer. The requirement is to calculate "the additional tax", not the chargeable value transferred. It does not affect the tax payable on other chargeable lifetime transfers and the additional tax payable is not itself affected by the requirement of s.113A(2) to disregard the relieving provisions in recomputing the tax on any earlier separate chargeable transfers.

Example:

In Year 1, Smith the controlling shareholder in a trading company Legirons Ltd, settles a holding carrying 15% of the votes (value £300,000) on the trustees of a discretionary settlement. In Year 2, Smith settles a further holding of shares in Legirons carrying a further 15% of the votes (value, say £400,000) on the trustees of a second discretionary settlement. In Year 3, an offer by Castle Keep Securities PLC (a company with a full Stock Exchange quote) for the entire issued share capital of Legirons Ltd is accepted and the trustees exchange their holdings for shares in Castle Keep Securities. Shortly thereafter, Smith dies. Smith makes no other lifetime gift. The additional tax payable in the case of the first settlement is £60,000 [40% of (£300,000 - nil rated £150,000]. In the case of the second settlement the additional tax payable is £100,000 [40% of (£400,000 - £150,000)]. If there had been earlier chargeable transfers (including any PETs becoming chargeable on the death) not then qualifying for 100% business property relief when made, the chargeable value transferred in the case of each settlement would be affected since part or all of the nil-rated band of chargeable transfers would have been comprised in these earlier transfers. If the two gifts had instead been made the subject of PETs (say, as interest in possession trusts), the tax payable by the trustees of the settlement made in Year 1 would (assuming there to be no other lifetime transfers) be £60,000, the tax payable by the trustees of settlement 2 would be £160,000 and other later chargeable transfers would be taxed at 40 per cent.[6]

So there may be some advantage in fragmenting gifts of business property qualifying for relief by gifting individual parcels of the property to separate bodies of trustees holding on the trusts of a discretionary settlement. This will be most obvious in those cases where it is thought likely that the business property will shortly be sold and not replaced by other property qualifying for relief. In such cases nothing is to be gained by ensuring that the trustees do themselves hold business property qualifying for the full 100% reduction (say, a holding of shares carrying more than 25% of the votes) in the value

6 The example assumes the trustees bear any tax (i.e., there is no "grossing up").

transferred. However, this course should be avoided where it is likely that the trustees will hold the business property for some time. In such cases it will plainly be to the advantage of the trustees to hold property qualifying for the full 100% relief as against 50% attaching (say) to holdings of shares carrying 25% or less of the votes.

Escaping s.113A - Continued Ownership by the Transferee

Absolute Gifts

Although s.113(3)(a) makes it a condition that the property shall be "owned" by the transferee at the death of the transferor within the 7 year period, the question of whether or not this condition is satisfied can best be answered by enquiring as to whether ownership has been lost. In many cases - at least where the property is not settled by the gift - the answer may be perfectly plain. The absolute owner of the gifted property will cease to be the owner when he sells or transfers the property or gifts the same to another. Events such as the purchase by a company of its own shares will result in a loss of ownership under this heading. Even here there is need for qualification. If the transferee settles the gifted property on trusts which confer on him or her an immediate interest in possession, he or she will not have ceased to be the "owner" of the property by virtue of the gift into settlement. Since he will continue to be treated as "beneficially entitled" to the property he will remain the owner. Subsequent events may conspire to result in a loss of ownership. But the mere gift into such a settlement will not result in the loss of relief on the death of the donor as a consequence of s.113A.

What of other events? Does the bankruptcy of the transferee result in a loss of ownership? This may in many cases be an academic question. If the event of bankruptcy itself does not result in loss of ownership, then ownership will be lost when the trustee in bankruptcy sells the shares. In my view, ownership of the bankrupt will cease on the commencement of the bankruptcy. S.306 of the Insolvency Act 1986 provides that the gifted property (with the other assets of the bankrupt) shall vest in the trustee in bankruptcy on his appointment. "Ownership" for the purposes of inheritance tax means beneficial ownership. So the mere vesting of the legal title to the gifted property in another will not affect the rights of the beneficial owner. But the powers, duties and functions of a trustee in bankruptcy in relation to the property vested in him (cf s.309 et seq Insolvency Act) are very far from being those of a nominee of the bankrupt. He is obliged by his statutory duties to get in the assets, realise the same so far as necessary and apply the proceeds in meeting the bankrupt's debts. His relationship with the bankrupt is not dissimilar to that of an executor in relation to a residuary legatee during the course of administration of the estate.[7] If bankruptcy of the intending donee is feared, it will be in the interests of donor and donee for the donor to settle the property qualifying for relief on protective trusts for the benefit of the donee.[8]

The letting out of property qualifying for the reduction of 50% in the value transferred (i.e., land or buildings let to a partnership or company in which the transferor and transferee had a controlling shareholding) will not result in a loss of relief. But unless the land or buildings is let to a partnership in which the transferee is a partner or to a company in which he has a controlling shareholding, relief on the death of the transferor within the 7 year period will be lost as a consequence of the application of s.113A(3)(b).

The charging of relevant business property by the transferee will not of itself occasion a loss of relief on the donor's death within the 7 year period since it will occasion no loss of ownership. But quite why the transferee would wish to charge the business property which will itself qualify for relief on any transfers of value made by him escapes me. If he has other assets not qualifying for relief he would be advised to charge those assets, thus reducing their inheritance tax value - rather than assets which qualify for relief in his hands.

Settled Property

Where the property is settled by the donor the position is less simple. But here again in most such cases the application of the basic principle presents no difficulty. The availability of relief depends on continuing "ownership" by the transferee. "Ownership" here has its inheritance tax meaning, which includes that of a beneficiary having an interest in possession who is to be treated as "beneficially entitled" to the shares or business property gifted (s.49 IHTA). "Transferee" is defined so as to comprise any person whose "property" the

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7 Decisions such as *Livingstone v Queensland Stamp Duty Commissioners* [1965] AC 694 and *IRC v Matthews Exors* [1974] STC 386 demonstrate the difficulty a beneficiary under a will who may appear, at first sight, entitled to consider the property vested in the executor to be "his property" is likely to have in claiming to be the owner of the property so long as some statutory or other administrative function of the executor remains to be performed.

8 The bankruptcy will not determine his interest in possession or result in a deemed transfer being made in such a case occasioning the loss of "ownership" conferred by the interest in possession (s.88 IHTA).

shares or other business property became as a consequence of the transfer of value (including the trustees of a settlement in which there is no interest in possession). If the trustees of an interest in possession settlement sell or advance the shares or other business property, the deemed transferee (the interest in possession beneficiary) will cease to be the owner of them. But he will also cease to be the "owner" of the shares or business property if his interest in possession comes to an end under the trusts contained in the settlement or under an exercise of their power by the trustees. So much is well understood. The risk of a loss of business property relief (on a transfer of value made by the settlor) as a consequence of the operation of the trusts in such circumstances is recognisable and avoidable. But there are cases where the danger may not be readily apparent.

(1) In some cases it is still possible for an annuity to be reserved out of the settled property. If no property is appropriated to fund the annuity the provisions of s.50(2) and (3) IHTA will have effect to deem the interest in possession to subsist in part of any shares or other business property the subject of the settlement. The annuitant will thus become an owner of the business property and a "transferee" within the definition. The termination of the annuity in the lifetime of the annuitant and within 7 years of the gift will result in the loss of "ownership" of that part of the shares or business property. So also will the appropriation of other settled property to answer the annuity. In these now somewhat unusual circumstances steps should be taken to avoid lifetime termination of the annuity (s.113A(4) prevents the disapplication of the relief on the death of the annuitant). Alternatively, property should be appropriated to answer the annuity prior to the gift into settlement of the shares or other business property.

(2) A more likely occasion of relief being lost as a consequence of the operation of s.113A occurs in the case of a settlement of shares or other business property qualifying for relief on members of a class. The problem here is not confined to accumulation and maintenance trusts considered below. Take a gift of shares or other business property to "such of my children as attain the age of 25 years". If all the children are entitled to interests in possession from the inception of the settlement the addition by birth or otherwise to the class of beneficiary will result in a partial loss of business property relief should the transfer made on the gift into settlement become chargeable on the death of the transferor/settlor within the 7 year period. If the beneficiaries are entitled to interests in possession from the inception of the settlement (entitlement to capital being deferred until the

attainment of a specified age) the class should be closed at once. Once again, the death of an individual class member entitled to such an interest in possession will not result in the loss of relief on the death of the transferor within the 7 year period.

(3) A not dissimilar problem may arise in the case of accumulation and maintenance trusts. Such trusts are more commonly used in conjunction with class gifts. Here relief may be lost in part, not merely by additions to the class which may operate to partly defeat interests in possession to which beneficiaries may have become entitled prior to the addition. In most cases - at least where the beneficiaries are infants - no member of the class who is below the age of 18 years is likely to have an interest in possession. This is most obviously the case with trusts to which s.31 of the Trustee Act 1925 applies. Now, where there is no interest in possession it is the trustees of the settlement who will be the "owners" of the business property qualifying for relief. If, whether under the trusts of the settlement or under the operation of s.31 of the Trustee Act, a beneficiary becomes entitled at 18 to an interest in possession in such a settlement, the trustees will thereupon cease to be the "owners" for the purposes of s.113A of the gifted shares or business property in which the interest in possession then comes to subsist. If that event takes place prior to the death of the transferor and the transferor dies within 7 years of the date of the gift, there will be a partial loss of relief.

This is a real trap for the unwary - in particular in those cases where the individual infants become entitled to interests in possession at the age of 18 years as a consequence of the operation of s.31 Trustee Act 1925.

If s.31 of the Trustee Act is to be left to operate as enacted, lifetime gifts of shares or other business property qualifying for relief to such trusts should be avoided unless all the potential beneficiaries in the class are less than 11 years of age at the date of gift. Alternatively, the trusts should be on terms which would ensure that no beneficiary becomes entitled to an interest in possession until 7 years after the making of the gift. As a further alternative, power may be reserved to the trustees to vary the shares which the beneficiaries take at the specified age - the exercise of which could be used (in combination with other powers) to prevent any one beneficiary becoming entitled to an interest until the first to happen of the death of the transferor or the elapse of the 7 year period from the date of gift.

(4) Given the nature of business property relief on a chargeable transfer of value, it is to be expected that transferors - whether the gifts be lifetime gifts or by will - are now more likely to settle the property qualifying for the full 100% reduction in the value transferred on discretionary trusts. The benefits to be obtained are not always, of course, as great as might be expected. For example, the gift of part only of a holding of shares carrying more than 25% of the votes (qualifying for full relief on the gift into settlement) may give the trustees shares which only qualify for a reduction of 50% in computing the value transferred on the "exit charge" or 10 year charges (ss.64 and 65 IHTA). Furthermore, in calculating the tax chargeable on the "exit charge" within the first 10 years, the claim to business property relief on the gift into settlement is to be disregarded in computing the value of the property entering the settlement (s.68 IHTA). Discretionary settlements (with most accumulation and maintenance trusts) presently remain subject to the discriminatory 35% capital gains tax rate on any gains. But this being said, the attractions of settling an interest in a business or shares in a company qualifying for the full 100% reduction in any value transferred on trusts which give to the trustees the usual wide powers of appointment and discretions as to income which are the hallmarks of discretionary settlements are sufficiently attractive as to make it likely that they will be the preferred vehicle for the gifts of such property as against the until now more usually preferred interest in possession or accumulation and maintenance settlements.

For the trustees there is a need to keep the provisions of s.113A in mind during the period of 7 years after the date of gift. An appointment of the relieved property on interest in possession trusts or to a beneficiary absolutely would, for example, be fatal to a claim for relief on the original gift of business property on the subsequent death of the transferor within the 7 year period. Similarly, an appropriation out of a mixed fund, comprising property qualifying for relief and property which does not, to interest in possession trusts will carry with it the risk of a loss of relief where the remainder of the property is held on trusts in which there is no interest in possession if the transferor dies within the 7 year period. Until the appropriation the trustees and the life tenant will each own a proportionate part of the business property qualifying for relief. Unless the appropriation between the interest in possession fund and the remaining trusts is of every asset on a *pro rata* basis the appropriation will result in a loss of "ownership" of part of the property qualifying for relief by either the life tenant or the trustees. This is not, however, a matter to be considered when drafting the trusts of the settlement, but rather a matter to be considered by the trustees when they come to exercise their powers.[9]

Settled Property - Deemed Transfer of Settled Property

In the lifetime of a settlement there are events which will either involve the making of an actual transfer of value (as on the death of a person entitled to an interest in possession) or which require inheritance tax to be charged as if a transfer of value had been made (the lifetime termination of an interest in possession or the 10 year periodic and "exit" charges imposed by ss.64 and 65 IHTA and the charges imposed when property ceases to be subject to accumulation and maintenance trusts or charitable trusts (ss.70 and 71(3) IHTA)). On such occasions any business property which the trustees are deemed to own (s.113A(8) IHTA) and which qualifies for relief as business property may result in a reduction or extinguishment of the charge on the trustees. The availability of business property relief in such cases is not affected by subsequent events. The deemed transfer of value in each case is made by the trustees rather than a "transferor" who can make a PET and whose death within the 7 year period will result in a charge.

But the above does not apply where the event by reference to which tax is or may become chargeable is the lifetime termination of an interest in possession in business property (s.52 IHTA). If the person, whether the trustees of the settlement or a beneficiary (not being the life tenant) who becomes the "owner" of the property following such lifetime termination, thereafter disposes of the relevant business property by way of gift, sale or otherwise (such as an appointment out of the fund), and the value treated transferred under s.52 IHTA becomes chargeable on the subsequent death within 7 years of the termination of the person formerly entitled to the interest in possession, business property relief will be lost. In most cases sensible planning and vigilance will make it relatively easy to avoid the loss of relief in such cases. It is a point to be kept in mind when the trustees come to determine whether, and if so to what extent, to exercise their powers of appointment, advancement or (where assets in addition to property qualifying for relief are held) appropriation.

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9 It is worth noting that an appointment out of a fund on maintenance and accumulation trusts (s.71 IHTA) will not of itself result in the trustees' ceasing to be owners of the business property appointed so long as no beneficiary is entitled to an interest in possession in the appointed fund.

The problem referred to in the foregoing paragraph does not arise where the interest in possession consists of a protected life interest which terminates in the lifetime of the principal beneficiary on the happening of one of the specified events described in s.33 of the Trustee Act 1925, for example the bankruptcy of the principal beneficiary. Although that event will bring the discretionary trust of income described in s.33(1)(ii) into operation the interest in possession of the principal beneficiary will not, merely as a result of that event, come to an end (s.88 IHTA).

Loss of Ownership - Exceptions

Predictably, there are exceptions to the general rule. In particular, the provisions of the TCGA under which shares or securities issued or received in exchange for the gifted shares on a reorganisation of share capital, reconstruction or take-over are treated as the same as the shares gifted are made to apply in much the same way (with one major qualification) to a claim to business property relief as they apply for the purposes of capital gains tax.[10] Furthermore, a transfer of a business or interest therein to a company in exchange for shares[11] will (again subject to one major qualification) not result in loss of relief (s.113A(6)).

The qualifications to which reference is made are these:

(1) A common feature of reorganisations, reconstructions and take-overs is the substitution for shares, not of other shares, but of loan-stock or other securities not consisting of share capital. The substitution of loan stock or other such securities will be fatal to the claim for business property relief on the subsequent death of the donor within the 7 year period unless those securities carry voting control. If the property is to qualify it must be relevant business property in the hands of the donee at the date of death of the donor - or earlier death of the donee. Shares may qualify as such property. Loan-stock or securities other than shares (unless carrying voting control) generally will not. There is, however, nothing to prevent the transferee taking preference shares in substitution for the gifted ordinary shares, and vice versa.

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10 Thus the requirement that the exchange or reconstruction must be for *bona fide* commercial reasons and not wholly or mainly to avoid tax must be satisfied.

11 Compare s.162 TCGA.

(2) If the subject matter of the gift is an interest in a business care should be taken to ensure that on the incorporation of the business the shares issued to the donee/transferee in exchange carry more than 25% of the voting power in the company. This will not affect the relief given on the transfer by the original donor. But it could have a prejudicial affect on the donee's own transfers of value - e.g., on his death. The interest in the business qualifies for the full 100% reduction. The holding of shares carrying 25% or less of the votes qualify for a reduction of only 50% as an item in the donee's inheritance tax estate or as a component in a trust fund held by trustees.

S.113B provides a more general exception for "replacement assets" paralleled in the TCGA by s.152 (which relates to individual assets employed in a trade) and now the new ss.164A to 164N introduced by s.87 FA 1993. This general exception is subject to conditions considered further below. For present purposes it suffices to comment that anyone advising a donee who is minded to dispose of the gifted business property qualifying for relief in the lifetime of the donor and within the 7 years of the gift should warn his client that the conditions for "rolling-over" any gain for capital gains tax purposes are not always the same as those intended to allow the original gifted property to be "rolled into" the replacement property.

There are other occasions where relief is provided (usually by way of roll-over) for capital gains tax purposes which will nonetheless result in a loss of ownership and consequential risk that business property relief will be lost on the death of the transferor. Shares or other assets received on a "de-merger" of a company the shares in which qualified as business property on the making of the gift (s.192 TCGA) are not treated as standing in place of the gifted shares. De-mergers will thus result in a failure to satisfy the ownership condition of s.113A(3)(a) unless this can be brought within s.136 TCGA (reconstructions). That is an unfortunate exception. "De-mergers" are in many cases occasioned by family feuds and are intended to allow the individual family members to own and manage the component parts of the successful family business built up under the ownership of their father (the donor). To preserve business property relief for shares gifted in the lifetime of the donor the transferees will in many cases be forced to adopt a "press-release" reconstruction for capital gains tax purposes.[12]

[12] The reference is to a reconstruction falling within s.136 TCGA as explained in Statement of Practice 5/85.

Whilst the relief is preserved where shares are exchanged for the business or interest therein on the incorporation of the gifted business, there is no corresponding substitution of an interest in a business received on the liquidation of the company the shares in which qualified for relief (i.e., on "disincorporation"). In such cases the transferees might, if there is a serious risk of the donor dying within the 7 year period, well be advised to sell their shares prior to the liquidation and purchase the business from the liquidator (as a replacement) within the 12 month period provided by s.113B IHTA.

The Nature of the Property in the Hands of the Transferee

If property which is the subject of a lifetime gift is to qualify for relief on the death of the transferor within the 7 year period it is not sufficient that the transferee should own that property or any "replacement" property throughout the period ended with the first to occur of his own death or the death of the transferor (if an individual). It must also be shown that, in relation to the transferee, the property would qualify for relief as business property in his (or their) hands if it had been the subject matter of a transfer of value or deemed transfer of value on the death of the transferor. For these purposes only it is unnecessary for the transferee to satisfy the 2 year ownership condition otherwise applicable if relief is to be claimed (s.106 IHTA).

Transferees who have surmounted the first hurdle in s.113A(3) (relating to continuing ownership) are unlikely to have as much difficulty in satisfying this second requirement. The property in their hands need not qualify for a reduction (on the notional transfer of value which s.113A(3) conceives to be made by them on the death of the transferor within the 7 year period) of the same percentage as that accorded to the transfer of value made on the gift. Indeed, it would be surprising if it was otherwise. A shareholder having a controlling holding qualifying him for relief by way of a reduction in the value transferred of the full 100% may wish to gift shares to each of his children in proportions giving each child less than 25% of the votes (attracting a reduction - assuming the company not to be quoted - of 50 per cent). It would be anomalous if the relief accorded on the transfer of value of the donor parent should be restricted by the form which the gift made to his children was to take.

Example:

Jones owns 60% of the issued ordinary shares in Thumbscrews Ltd (an unquoted trading company). He proposed to gift half his holding to his three children equally. The value transferred attributed to this transfer by way of gift qualifies for the full reduction in the value transferred of 100 per cent. The fact that any value attributable to a transfer by a child of his or her holding would qualify for a 50% reduction only does not affect the quantum of reduction on the original gift.

It is immaterial that any business property relief which would be accorded on the transfer of value deemed to be made by the transferee on the death of the transferor within the 7 year period would be cut down by reference to the value of any "excepted assets" (s.112 IHTA). The question of whether, and if so to what extent the value of any "excepted assets" affects the quantum of the value transferred qualifying for relief has to be looked at at the date of the gift - not at the date of the death of the transferor.

Example:

At the date of the gift of the shares in the previous example the assets of Thumbscrews Ltd do not include "excepted assets". Subsequently to the gift Thumbscrews Ltd sells one of its two factories and acquires a holding of shares in a quoted company as an investment and arranges to let out part of its office premises. Its main activity, however, remains a business activity qualifying the shares for relief as business property in the donees' hands. The acquisition of these excepted assets will not result in any loss of relief on the original gift by Jones.

Intending transferors owning interests in a qualifying business or shares in a company qualifying for relief as relevant business property should not overlook the opportunity presented to them of planning gifts to coincide with a time when the value of any "excepted assets" underlying any gift is nil or at any rate greatly reduced. The older the owner of business property, such as a controlling shareholder, the less active he or she is likely to be. In such a case the proportion of investments and other excepted assets held as part of the assets of the business is likely to be greater. A somewhat similar point can, however, be made whatever the age of the intending transferor. It is seldom possible to ensure that the value of excepted assets held as part of the assets of a company or partnership is reduced to nil on the occasion of some event which cannot be planned in advance - such as death. By judicious planning, however, a reduction in value of excepted assets can be achieved in advance of a planned event such as a gift of the shares or other assets qualifying for relief. For example, a loan could be raised on the security of the excepted assets reducing their value in accordance with s.162(4) IHTA and the money so raised utilised to purchase other assets for use in the trade concerned prior to the gift.

Problem Areas

Subject to these qualifications, it is essential that the property (including any replacement property) owned by the transferee at the death of the transferor within the 7 year period falls within one or other of the descriptions of relevant business property found in s.105 in relation to the transferee. There may be occasions when relief will be lost as a consequence of the nature of the property gifted or alternations in its character between the date of gift and the date of the donor's death. Two were mentioned by Alasdair Benzie in his article referred to at footnote 2:

(1) No relief will be available on a PET (or gift to the trustees of a discretionary settlement) becoming chargeable where the value transferred is attributable to relevant business property consisting of land or plant and machinery let to a company controlled by the transferor unless control of that company is either then or subsequently obtained by the transferee prior to the death[13]. To qualify for relief as business property the company must be controlled by the transferor at the date of gift and by the transferee at the date of the death of the transferor within the 7 year period. This may well put paid to many schemes having as their object the hiving off of major assets of the business with the object of producing an income for those family members not actively participating in the business. The problem is easier to avoid where relief is sought for property let to a partnership. It will in general be possible for a transferee to be and become a partner entitled to only a modest share of profits and liable for only a small share of losses and claim for relief as relevant business property any land, plant or machinery let to the partnership. Relief would be available even in cases where the person concerned is a limited partner.

(2) Business property relief which was obtainable on a transfer may be lost if shares which are the subject of a lifetime gift become quoted on the Stock Exchange prior to the death of the transferor/donor within the 7 year period. This will be so in all cases where shares held by the transferee at the date of death comprise a holding carrying less than 50% of the votes. It is only a controlling shareholding which will

[13] Entitled to a reduction of 50% in the value transferred.

retain its status as business property qualifying for relief following a quote. These limitations only apply to a full listing of the shares. Quotations of the shares on the unlisted security market do not disqualify minority holdings from business property relief in the hands of the transferee.[14]

One limitation mentioned above in connection with ownership also applies here. Loan-stock or other securities not falling within the description "shares" do not qualify for business property relief unless they carry voting control over the company concerned (with or without shares owned by the transferor). The conversion of shares into loan-stock may not itself result in a loss of "ownership". But in the event of the conversion of shares into such stock - or, for example, a bonus or rights issue comprising loan-stock or other securities not being shares - business property relief on the original gift of the shares subsequently becoming chargeable may be lost. That may be of particular importance in planning the capital structure of the company. Enquiry may now have to be made of shareholders who have made gifts in every case where a reorganisation or take-over of a family company is in contemplation.

It should also be kept in mind that shares will cease to be relevant business property once the company in which the shares are held goes into liquidation (s.105(5) IHTA) unless it be shown that the liquidation is part of a scheme of reconstruction.

Although the acquisition of excepted assets subsequent to the gift will not of itself result in a loss of relief on the death of the transferor within 7 years from the gift, it should not be forgotten that the business of the company (or its subsidiaries in the case of a group parent) or where the business is not owned by a company the business itself must at the date of the transferor's death consist wholly or mainly of an activity not falling within the prohibited categories in s.105(3) IHTA (i.e., a business consisting wholly or mainly of the dealing in or holding of land, investments, etc.). Provided the transferee retains "ownership" it is immaterial that the gifted property may temporarily lose its character as relevant business property qualifying for relief in the period between gift and the death of the transferor. But it would be folly consciously to plan a course which may result in loss of relief in the event of the premature death of the tranferor or the transferee.

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[14] The holdings of the spouse of the transferee will count in determining whether he has a controlling holding of shares which are quoted.

Replacement Property

S.113B IHTA provides what at first blush appears as an extensive and welcome exception from the disapplication of the relief in cases where the transferee has ceased to be the owner of the property. Closer examination shows that the exception is not as extensive as at first appears.

(1) Typically, s.113B applies on a sale of the relevant business property which was the subject of the original lifetime gift. It matters not whether the property was shares in a company, a business or interest in a business, or other assets let for the purpose of the business. Nor, subject to what follows in (2), is it material that the "replacement property" acquired with the proceeds is of a different character to the property gifted.

(2) Typically, s.113B is applicable in those cases where capital gains tax "roll-over" relief is available either on a disposal of assets such as land or buildings or goodwill used in the course of a trade or business (s.152 TCGA) or on a disposal of shares in a family trading company under the new relief now found in ss.164A to 164N. In some respects the relief conferred by the capital gains tax roll-over provisions is narrower: s.152 requires the consideration received on the disposal of the land, buildings, etc. used in the trade to be applied in acquiring other of the specified assets for use in the same or another trade carried on by the person making the disposal. Capital gains tax roll-over relief is limited where the new assets are "wasting assets". Likewise the new provisions of ss.164A to 164N permitting the roll-over of gains accruing on a sale of shares in a family trading company only allow for relief if the consideration is applied in the purchase of or subscription for other shares. These limitations do not apply to the relief provided by s.113B. The proceeds of sale of shares can be used to purchase an interest in a business and vice versa. But the lack of availability of capital gains tax roll-over relief in such cases is material when planning disposals.

(3) In other respects s.113B is more limited. Thus the person disposing of the original gifted property has only one year[15] in which to apply the

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[15] If the proposals to be incorporated in the Finance Bill become law replacement of the gifted property within three years of the disposal will qualify the replacement property for relief. The provisions will thus be more closely aligned with those relating to capital gains tax roll over relief.

proceeds in the purchase of the replacement property - not three as in s.152 and s.164(9)(a) TCGA. It is not intended to allow the donee to acquire the replacement property before disposing of the original property (see s.113B(2)(a) - the acquisition must be within 12 months[16] **after** the disposal). In one small respect here the provisions are an improvement on the capital gains tax provisions. If a trader disposes of an asset used in his trade and dies before entering into a contract to purchase the replacement asset his ability to rollover the gain on the disposal in his lifetime will be lost. If the donor of the business property dies in such circumstances (i.e., after the disposal but before acquisition of the replacement property) business property relief will still be available if the donee enters into the contract to purchase the replacement property within 12 months[17] of the original disposal (s.113B(5) IHTA).

(4) The original property can be replaced only once. The exception in s.113B does not apply to replacements of replacements.

(5) The disposal and acquisition must both be at the very least on terms which would be made in a transaction at arm's length. This gives rise to one interesting anomaly which may present a planning opportunity. As already mentioned, the grant of a lease of business property will not of itself result in loss of ownership (although it may result in the property ceasing to be business property for the purposes of the relief). Ownership will be lost if the reversion expectant on termination of the lease is then sold. However, the terms of sale will reflect the existence of the lease and can themselves result in a substantially smaller sum being received. It is that consideration, and not the larger sum which might have been received on a sale with vacant possession, which is to be applied in purchase of the new assets.

(6) The whole of the consideration received on the original sale must be applied in acquiring the replacement property. This contrasts with the capital gains tax roll-over relief found in s.152 TCGA which cuts down the relief there given where only part of the consideration is applied in acquiring the new assets but does not necessarily prevent relief applying. In his article Alasdair Benzie referred to the problem likely to be occasioned (assuming capital gains tax roll-over relief not to be

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16 To be increased to three years - see IR press release, 30th November 1993.

17 See footnote above.

available) by this requirement where part of the proceeds of a sale had to be applied in paying capital gains tax. In my view the reference to the "whole" of the consideration is unequivocal: one is not entitled to claim to be within the exception conferred by s.113B if part of the consideration received is applied in paying capital gains tax.

(7) The relief is not capable of application to events other than an actual disposal resulting in the receipt of consideration. It can apply therefore on a purchase by a company of its own shares but not where assets are received on the liquidation of a company or on a demerger. In cases of that kind, a prior sale of the gifted property and purchase of the assets received in exchange may be necessary if business property relief is to be preserved.

Death of the Transferee

If the transferee[18] dies within the 7 year period but before the transferor, the question of whether or not the gifted property qualified for business property relief on the original transfer of value has to be considered by looking at the position at the date of the transferee's death (ss.113A(4) and 113B(4) IHTA). The condition as to continuing ownership by the transferee must be satisfied up to the date he dies. But sales of the business property or other dispositions resulting in loss of ownership after his death but before the death of the transferor within the 7 year period will not result in a loss of relief. This at least is helpful. But it is still necessary to satisfy the test that the property qualified for business property relief in the hands of the transferee at the date of his death (the two year ownership condition being disregarded for these purposes).

Intending transferors facing an imminent sale of business property qualifying for relief under s.104 IHTA with no intention of replacing the same with other property qualifying for like relief could preserve business property relief in respect of a lifetime transfer by settling the property on a transferee with limited life expectancy, with the remainder to the children or remoter issue or other persons whom the transferor intended to benefit. The sale of the business property following the death of the life tenant would not result in a loss of business property relief accorded on the gift into settlement by the transferor. Those tempted to embark on this course should, however, be reminded that if

[18] Of necessity this must be an individual absolutely entitled to or to an interest in possession in the property.

business property relief is to be claimed in respect of the transfer of value attributable to the business property relief on the death of the person selected as having a limited life expectancy, that life interest must subsist for at least two years so as to satisfy the ownership condition in s.106 IHTA. If the selected life tenant fails to survive the two year period the market value of the settled business property (unreduced by any relief) will be aggregated with the remainder of the property the subject of a chargeable transfer on the life tenant's death, with a consequential risk of a substantial charge and loss of any savings. A gift of business property taking this form is unlikely to be of any use unless the life tenant has a life expectancy of more than two years and the sale can be postponed for that time.