BUSINESS PROPERTY RELIEF: REORGANISATION OF SHARE CAPITAL

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Business property relief for inheritance tax purposes is given by section 104 IHTA 1984 at the rate of 50% or 100% for various classes of "relevant business property". This includes unquoted shares in a trading company, or more accurately a company whose business does not consist wholly or mainly of dealing in stocks and shares, land or buildings or making or holding investments. A shareholding in an unquoted company that carries on a qualifying business can be relevant business property in three different ways:

(i) Under s.105(1)(b) where the shares (either by themselves or together with other such shares owned by the transferor) gave the transferor control of the company immediately before the transfer. The relief given in this case is 100%.

(ii) Under s.105(1)(bb) where the shares do not give the transferor control as in (i) above but where immediately before the transfer the shares (either by themselves or together with other shares owned by the transferor) gave the transferor control of powers of voting on all questions affecting the company as a whole which if exercised would have yielded more than 25% of the votes capable of being exercised on them. The relief given in this case is also 100%.

(iii) Under s.105(1)(c) where the shares do not fall within (i) or (ii) above. The relief given in this case is only 50%.

Accordingly, if I have a holding of 49 ordinary shares out of 100 issued shares in an unquoted trading company and have held them for at least two years, they represent relevant business property on which I am entitled to 100% business

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property relief because the shares are property falling within category (ii) above; they satisfy the requirements of s.105(1)(bb).

However, let us assume that there is a bonus issue of 10,000 shares. My shareholding would be increased by 4,949 shares, still representing 49% of the issued share capital. If I were to die within two years of the bonus issue the question might arise whether I am entitled to business property relief on all the shares because I would not have held them for the normal two year qualifying period. This condition is imposed by s.106 which says:

> "Property is not relevant business property in relation to a transfer of value unless it was owned by the transferor throughout the two years immediately preceding the transfer."

This would represent a serious problem in respect of the bonus shares if it were not for s.107(4) which conveniently comes to the rescue by providing that:

> ".... where [shares falling within Section 105(1)(bb) or (c)] owned by the transferor immediately before the transfer would under any of the provisions of sections 126-136 TCGA 1992 be identified with other shares previously owned by him, his period of ownership of the first-mentioned shares shall be treated for the purposes of section 106 above and section 109A below as including his period of ownership of the other shares."

A bonus issue is a reorganisation within the meaning of s.126 TCGA 1992 and the bonus shares are identified with the original holding by s.127. Therefore, providing I have held my original 49 shares for two years, I would be entitled to business property relief on the whole of the 4,949 shares. This is no great surprise. Common sense dictates that the relief should be preserved because both before and after the bonus issue I have 49% of the company's issued share capital. In all material respects my position is entirely unchanged. If I was entitled to business property relief before the bonus issue I should be entitled to it afterwards.

However, what if I had held 99 shares in this company representing 99% of the ordinary issued share capital and had received 9,900 bonus shares in the reorganisation within two years of my death. Does the same reasoning apply? Unfortunately it does not.

Before the bonus issue my 99 shares represented relevant business property falling within s.105(1)(b) above and I was entitled to 100% relief. After the bonus issue I still had 99% of the issued share capital and I was still within s.105(1)(b). However, I did not hold the 9,900 bonus shares for two years immediately preceding death and again, unless there is some relieving provision, s.106 would operate to deny me the relief. Naturally we turn to s.107(4) for this relief - but regrettably it does not come to the rescue this time.

Although there has clearly been a reorganisation within s.126 TCGA 1992 and my bonus shares would be identified with my original holding by s.127, s.107(4) does not apply. The section refers only to shares falling within s.105(1)(bb) or (c) - but my holding falls within neither of these; it falls within s.105(1)(b). There is nothing else to prevent the application of s.106 and accordingly only 99 out of my 9,999 shares will qualify for business property relief - which of course eliminates the entire relief for all practical purposes.

This result is so bizarre as to be almost incredible. One suggested solution might be to argue that the bonus shares represent "replacement property" so that they may benefit from the relaxation provided by s.107(1) which says:

> "(1) Property shall be treated as satisfying the condition in section 106 above if:
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> (a) it replaced other property and it, that other property and any property directly or indirectly replaced by that other property were owned by the transferor for periods which together comprised at least two years falling within the five years immediately preceding the transfer of value, and
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> (b) any other property concerned was such that, had the transfer of value been made immediately before it was replaced, it would (apart from section 106), have been relevant business property in relation to the transfer."

However, this seems to be a difficult argument because the 9,900 bonus shares do not replace my original holding of 99 shares; they merely add to the number of shares in my possession. If it were possible to say that the aggregate holding of 9,999 shares is a new asset which replaces the old asset which comprised 99 shares, s.107(1) would save the day. This would certainly be possible under the capital gains tax legislation. Under s.104(1) TCGA 1992 the new holding of 9,999 shares would be regarded as a separate single asset - thereby replacing the previous asset of 99 shares. However, this provision has no application to inheritance tax and has no counterpart in the inheritance tax legislation. It is therefore not easy to see how such an argument could be sustained.

Nevertheless, there are indications that the Capital Taxes Office may be prepared to adopt such an approach. This is obviously very helpful because otherwise an event as apparently innocuous as a bonus issue could expose a major shareholder to the loss of his business property relief if he were to die within two years.