SECTION 39A IHTA - DOES IT WORK?

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1.1 Agricultural property, interests in a business or shares qualifying for relief as relevant business property belonging to an individual will, as property to which he is beneficially entitled, be the subject of a transfer of value on his death as part of his inheritance tax "estate" (s.4 IHTA 1984). As part of that estate the value of such agricultural property or relevant business property satisfying the conditions for relief will be reduced by 30 per cent or 50 per cent, as the case may be, as prescribed by s.104 and s.116 IHTA.[2]

1.2 The reduction is made before determining the extent to which the transfer of value on death is "exempt". The principal exemptions available in respect of transfers on death apply where the value transferred is attributable to property gifted to the spouse of the deceased (s.18 IHTA) or to charities (s.23 IHTA). If the entirety of the estate is gifted to the spouse of the deceased or to charity or to some combination of the two the whole of the value transferred on death will be exempt and the value of the shares or other property and their status as relevant business property is irrelevant. But if part of the value transferred by a transfer of value is the subject of an exempt transfer of value and part is chargeable the availability of relief accorded to agricultural or business property will be relevant in determining the quantum of the chargeable value transferred by reference to which the charge on death is imposed.

Transfers before 18th March 1986

1.3 In the case of transfers of value made prior to 18th March 1986 it was possible to achieve a substantial saving of inheritance tax where the transferor had property qualifying for relief as agricultural or relevant business property by the simple expedient of making a specific gift (by will) of such property to his or her spouse or to charity. The reasoning behind such schemes ran as follows: the exemption given by (in the most common case) s.18 IHTA is accorded to so much of the value transferred as is attributable to property gifted to the spouse or, to the extent that it is not so attributable, to the extent that the inheritance tax estate of the spouse is increased. The reductions accorded to relevant business or agricultural property, however, are accorded not to the property as such, or to the value of a person's "estate" as such, but to the value transferred attributable to such property. A question

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[2] The conditions to be satisfied are in ss. 103-114 IHTA (business property) and ss.115 to 124 (agricultural property). The percentage reductions depend (in the case of business property such as shares) on the nature of the property and (in the case of agricultural property) on whether or not vacant possession can be obtained.

might be said to arise as to whether this reduction was accorded to the property specifically gifted to the spouse and accordingly as to the extent to which that property was exempt under s.18. S.36 IHTA provides:

> "Where any one or more of sections 18, 23 to 27 and 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 ..."

1.4 It is unnecessary for the purposes of this article to comment on s.37 (abatement of gifts) or s.40 (gifts made out of different funds). Where a "question" arises as to the extent to which the specific gift to the spouse of agricultural or business property is exempt attention is focused on the provisions of s.38 (attribution of value to specific gifts). This provision applies most obviously to cases where specific (including pecuniary) legacies expressed to be free of tax are the subject of chargeable transfers of value and the residue or a share therein is gifted to the spouse. Since residue will bear the tax attributable to the specific gifts a question will arise under s.36 in all such cases as to the extent to which the exemption in s.18 applies and it will be necessary to operate the convoluted machinery of s.38(3) to (5) involving the "double grossing up" of the chargeable legacies so as to calculate the value of the residuary estate to which the exemption is to be accorded.

1.5 Section 38(1) provides:

> "Such part of the value transferred shall be attributable to specific gifts as corresponds to the value of the gifts; but if or to the extent that the gifts -
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> (a) are not gifts with respect to which the transfer is exempt or are outside the limit up to which the transfer is exempt, and
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> (b) do not bear their own tax,
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> the amount corresponding to the value of the gifts shall be taken to be the amount arrived at in accordance with subsections (3) to (5) below."

This provision posed no problems for specific gifts of business or agricultural property gifted to a spouse on a transfer of value made prior to 18th March 1986. Whether the gift was expressed to be subject to tax or not the question as to the extent to which it was exempt was answered by according the exemption to the market value of the property gifted before the reduction accorded to the property as agricultural or business property. Take, by way of illustration, a transferor dying before that day possessed of a farm (and no other assets or liabilities) having a market value of £1,000,000 qualifying for the reduction in the value transferred of 50 per cent. By his will he made a specific gift of a half share in the farm to his spouse, the other half being left on trusts declared concerning his residuary estate in favour of his children. The "value transferred" on death reduced by 50 per cent was £500,000. As a consequence of s.38 IHTA the value of the specific gift to the spouse was the value of the half interest in the farm - also £500,000. The value transferred was therefore exempt to that extent. So no tax was payable notwithstanding the fact that the children as the beneficiaries under the trusts declared concerning residue benefited by the receipt of property to the value of £500,000.

Section 39A IHTA

1.6 This was the sort of mischief at which s.39A (inserted by s.105 FA 1986 in relation to transfers of value made after 17th March 1986) was aimed. The section is as follows:

> "(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 purposes of attributing the value transferred (as reduced in accordance with sections 104 to 116 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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> (2) The value of any specific gifts of relevant business property or agricultural property shall be taken to be their value as reduced in accordance with section 104 or 116 below.
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> (3) The value of any specific gifts not falling within subsection (2) shall be taken to be the appropriate fraction of their value.
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> (4) In subsection (3) "the appropriate fraction" means 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 subsection, and
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> (b) the denominator is the difference between the unreduced value transferred and the value, before the reduction mentioned in subsection (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.
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> (5) If or to the extent that specific gifts fall within paragraphs (a) and (b) of subsection (1) of section 38 above, the amount corresponding to the value of the gifts shall be arrived at in accordance with subsections (3) to (5) of that section by reference to their value reduced as mentioned in subsection (2) or, as the case may be, subsection (3) of this section.
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> (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 be treated as a specific gift of relevant business property or agricultural property.
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> (7) In this section
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> "agricultural property" and "the agricultural value of agricultural property" have the same meaning as in Chapter II of Part V of this Act; and
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> "relevant business property" has the same meaning as in Chapter I of Part V."

1.7 Now there is no disputing that these provisions, specifically subs.(2), strike down the simple means of mitigating the charge to inheritance tax outlined in para 1.5 above. Thus, to revert to the example, the effect of these provisions is to deem the gift of the half interest in the farm to the spouse to have a value for the purposes of the exemption accorded by s.18 of £250,000. The balance of the value transferred (£250,000) would be the subject of a chargeable transfer. What then of other arrangements involving testamentary gifts?

1.8 The first point to note is that subs.(2) is not a purely anti-avoidance measure. It is capable of operating in a benevolent manner. If agricultural property was the subject matter of a specific gift free of tax to chargeable legatees (the residue being gifted to the spouse) a question would arise as to whether the "value" of the specific gift for the purposes of the spouse "exemption" was its value as reduced for the purposes of calculating the total value transferred on death or its value before the reduction accorded to such property. Before the coming into force of s.39A it was arguable that the latter was the case with the result that the value of the residuary estate to which the exemption was accorded calculated in accordance with s.39 would be correspondingly reduced. The provisions of subs.(2) of s.39A mean that the former applies with the result that the "exempt" residue will be increased by the amount of any relief accorded to the chargeable specific gifts.

1.9 The operation of these provisions is less clear where agricultural or relevant business property is specifically gifted to the spouse in combination with other "specific gifts" such as pecuniary legacies or property specifically gifted to chargeable legatees. It was apparently intended to provide for this event by s.39A(3) to (5) which reduce the value of the specific gifts not qualifying for business or agricultural property relief to the "appropriate fraction" of their value before applying the provisions of s.38. The object of subss.(3) and (4) in such cases appears to be to share out the benefit resulting from the reduction in the value transferred attributable to any business property or agricultural property which is not specifically given and which therefore enures for the benefit of the estate as a whole.

1.10 The definition of the "appropriate fraction" does not fit happily with a situation in which there are no specific gifts of property qualifying for business or agricultural property relief. This eventuality would be better covered by providing that where there were no specific gifts qualifying for business or agricultural property relief the appropriate fraction would be that of which the numerator was the value transferred reduced by the relief and the denominator was the unreduced value transferred. One would have expected that there would at least be specific gifts qualifying for relief as mentioned in subs.(2) so as to point to a "difference" between the figures. But in my view subs.(4) is fully capable of applying to cases where there are no specific gifts qualifying for business or agricultural property relief as it does to cases where there are such gifts.

1.11 In cases where s.39A(3) to (5) apply the sharing of the benefit of the relief cuts both ways. On the one hand it reduces the value of any exempt pecuniary or other specific legacies (of property not qualifying for relief) given to the spouse which might otherwise qualify for exemption. On the other it reduces the value of any specific chargeable legacies thus increasing the value of the exempt residuary estate gifted to a spouse and charged with the payment of the inheritance tax on the specific gifts. The crucial question is "when does s.39A apply?"

When does s.39A apply?

1.12 It is open to question whether s.39A strikes down the mischief at which it was apparently aimed in every case. This is not so much the fault of the section itself as of the context in which it is placed. It is only ss.38 and 39 IHTA which are expressed to have effect subject to s.39A. Neither s.18 (the spouse exemption) nor s.23 (the charity exemptions) to mention the two principal categories of exempt transfers are expressed to be subject to s.39A. Yet these provisions are unqualified in their terms. They are not "subject" to ss.38 and 39 and there is no indication in either ss.18 or 23 that the relief thereby given may be cut down by ss.38 or 39. Yet the conventional view and the view of the Capital Taxes Office is that ss.38 and 39 when considered in conjunction with s.39A, have precisely that effect.

1.13 Take, for example, a testator who dies leaving a controlling holding of shares qualifying for business property relief having a value (before such relief) of £200,000. He has other assets to a value of £300,000 after payment of debts. By his will he leaves an "exempt" pecuniary legacy of £100,000 to his widow. The residuary estate is gifted to his children. It will be seen that the residue is more than sufficient to meet the liability for inheritance tax in full. At first sight one would have no hesitation in advising that £100,000 of the value transferred on the death was the subject of an "exempt" transfer as being attributable to property given to or becoming comprised in the estate of the widow. But conventional wisdom would have one "share out" the benefit of the business property relief accorded to the shares between the specific gifts to the widow and residue. The value of the "exempt" legacy to the widow is thus cut down by the "appropriate fraction" of 4/5 from £100,000 to £80,000. Although the widow receives her £100,000 in full the chargeable estate on which tax is to be paid is £320,000 and not £300,000. If Parliament had given its collective mind to this issue it is unlikely to have intended such a capricious result flowing from such a construction.

1.14 In my opinion this conventional view which would apply s.39A in such a case is misconceived. This section along with ss.38 and 39 is part of Chapter III in Part II of the IHTA which is headed "Allocation of exemptions". It is introduced by s.36 which provides that where ss.18, 23 to 27 or 30 apply in relation to a transfer of value but the transfer is not wholly exempt "(a) any question as to the extent to which it is exempt ... shall be determined in accordance with sections 37 to 40 below." If it had been intended to take away the relief so clearly provided by s.18 or s.23 one would have at the very least expected s.36 to have provided not that "any question" as to the extent of the relief should be determined in accordance with ss.37 to 40, but merely that the "extent of that relief" should be so determined.

1.15 It is only where ss.18 or 23 leave room for doubt as to the true extent of the exemption thereby conferred that a "question" can arise as to the extent of the exemption. It is not difficult to see how such a question might arise. If a testator dies leaving a number of chargeable legacies free of tax to his children and his residuary estate to his widow the extent of the exemption in s.18 would be unclear because the extent of the property becoming comprised in the estate of or gifted to the widow would be made to depend on the tax charged in respect of the chargeable specific gifts. The extent of the exemption would also be unclear where (a) part of the residuary gift was "exempt" and part chargeable, or (b) where the gift to a widow or charity was a specific gift of relevant business property. But how can a question arise as to the extent of the exemption where a specific gift is given to a spouse of property not qualifying for relief?

1.16 Section 39A succeeds in its object of setting at nought the saving otherwise

achieved by the simple expedient suggested in para 1.5 of a specific gift of relevant business or agricultural property to a charity or widow. How does it apply in other cases?

The effect of s.39A

1.17 If one keeps in mind the principle that s.39A only applies where a "question" arises as to the extent to which the transfer of value is exempt the scope of application of the section becomes clear. Take the simple example mentioned in para 1.13 (specific gift to widow of £100,000, chargeable residue £400,000). There is no "question" as to the extent of the exemption and therefore no room for the application of ss.38 or 39 (and therefore of s.39A). The position would have been the same if the shares had been specifically gifted to one of the testator's children (the pecuniary legacy to the widow being retained in the will as before).

1.18 But what would be the position if the testator had gifted a pecuniary legacy of £200,000 to one of his children and his residuary estate to his widow? But for the provisions of s.39A(3) and (4) the chargeable specific gift consisting of the legacy would, if it was expressed to bear its own tax, have a value of £200,000. The relief accorded to the shares as relevant business property would be unused. If the pecuniary legacy was expressed to be "free of tax" (residue being left to bear that tax as a testamentary expense) the value of the specific gift "grossed up" under s.38(3) to (5) (which would reduce the exemption accorded to the exempt residue) would, but for s.39A, take no account of business property relief. Business property relief would, of course, have been given in the sense that the value transferred would be reduced by £100,000 (in the example). But the exemption accorded to the residuary gift to the widow would have been cut down by an amount which did not reflect this. The provisions of s.39A provide relief in both such cases by reducing the value of the pecuniary legacy whether for the purposes

of determining the value on which tax is payable (on subject to tax gifts) or for the purposes of "grossing-up".[3]

Wills and Estate Planning

1.19 How then does s.39A apply to dispositions of estates structured so as to maximise the advantages to be gained from the reliefs and exemptions? A gift of shares qualifying for a 50 per cent reduction in the transfer of value attributable thereto as relevant business property to the widow of the transferor would only be "exempt" to the extent of the value so reduced. Could s.39A result in a loss of the exemption in less obvious cases? Take the case of a testator dying leaving an estate valued (before any reduction for business property relief) at £2,500,000. Part of the estate comprises shares worth £2,000,000 qualifying as relevant business property to a reduction in the value transferred attributable thereto of 50 per cent. By his will he leaves one half of the shares to his sons and a pecuniary legacy of £1,000,000 to his widow. Tax is to be borne by residue (the trusts declared mean that it is the subject of a chargeable transfer). As a consequence of business property relief the value transferred on his death is £1,500,000. The conventional wisdom of the CTO would have it that, as a consequence of s.39A, the value of the gift of shares to the sons is reduced by 50 per cent to £500,000 and the value of the pecuniary legacy to the widow by the "appropriate fraction" of £1,000,000. In the instant case this would be the fraction of which the numerator is £1,000,000 (i.e, £1,500,000 less £500,000 - the reduced value of the shares gifted to the sons) and the denominator is £1,500,000 (£2,500,000 less £1,000,000 being the unreduced value of the shares gifted to the sons). So there would be a chargeable transfer of some £833,333 (£2,500,000 less £1,000,000 (business property relief on shares of a value of £2,000,000) less 2/3 of £1,000,000).

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[3] It is possible to conceive of less simple cases involving specific gifts of property not qualifying for relief to the widow to which the "appropriate fraction" in s.39A might apply. Where specific gifts of property not qualifying for relief are given to the widow and others and a residuary gift including property qualifying for relief is given to the widow a "question" might be said to arise as to the extent to which the residuary gift and the specific gift to the widow were "exempt". In that event the "appropriate fraction" in s.39A would operate to reduce the value of the "exempt" specific legacy gifted to the widow along with the value of the other specific gifts. The exemption would not, however, be lost because the value of the "exempt" residue would be increased by the like amount.

1.20 But on the interpretation of these provisions put forward in paras 1.14 and 1.15 the transfer of value would be exempt to the sum of £1,000,000 which is the value of the pecuniary legacy gifted to the widow. It is immaterial that some of the shares qualifying for relief would have to be sold or appropriated to meet the legacy. The widow's estate is increased by the pecuniary legacy of £1,000,000 given to her. No "question" arises as to the extent to which the transfer of value is exempt which would bring ss.37 to 40 into operation. On this analysis the exempt gift to the widow would reduce the chargeable value transferred to £500,000.

1.21 The conventional interpretation of s.39A as it applies in such cases is consistent with a view of the section which attributes to it an intention to strike at the "mischief" consisting of the manipulation of the exemptions accorded by ss.18 and 23 (to mention the most obvious cases) where the estate comprises relevant business or agricultural property so as to enable a claim for double relief to be made. But if the provisions are construed in this manner there is no stopping point short of an interpretation which gives rise to the capricious results of the kind described in para 1.13 which would have one cut down the spouse and charity "exemption" in cases where recourse to property qualifying for relief need not be had to satisfy the specific gift to the spouse or charity as the case may be.

1.22 Even if the conventional interpretation applying s.39A in such cases is correct these provisions will not eradicate the mischief at which they are apparently aimed. The debts of a person, not falling within s.103 FA 1986, are deductible in computing the value of his estate on his death. Unless they consist of the liabilities of the business or are charged specifically on any relevant business property or agricultural property, debts will not reduce the value of such property qualifying for relief. So the estate of a deceased comprising only property qualifying for a reduction in the value transferred attributable thereto of 50 per cent as relevant business property relief having an unreduced value of £2,000,000 and debts (not charged on that property) of £1,000,000 would have a nil value for the purposes of inheritance tax. If the debt of £1,000,000 had resulted from a borrowing by the deceased a week before he died, which sum he had then gifted to his wife, the whole of the value transferred by that gift would be exempt - even on the conventional view of s.39A.[4] If he had not borrowed the money required to make this gift and had instead gifted the £1,000,000 as a pecuniary legacy the conventional view would have it that only one half of that legacy would be treated as "exempt" for the purposes of s.38 IHTA.

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[4] Much the same effect could be achieved where the estate included property not qualifying for business or agricultural property relief by specifically charging the unrelieved property in the estate with the debt created on making the inter vivos gift to the spouse: viz, an estate comprised of shares qualifying for business property relief of 50 per cent having a value of £1,000,000 and unrelieved property of £1,000,000 the latter being specifically charged to secure debts of £1,000,000.

Conclusion

1.23 Relief given to relevant business property and agricultural property and the exemptions accorded to gifts to spouses and charity will continue to influence the form of wills and other dispositions. If the CTO's interpretation of s.39A is accepted as correct, the most tax efficient means of disposing of relevant business property such as shares or agricultural property by will where the testator is survived by his spouse is to bequeath the entirety of the property qualifying for relief specifically to the chargeable legatees whom it is wished to benefit - whether expressed to be subject to tax or not. If the narrower interpretation of s.39A preferred in para 1.15 is accepted as correct and the testator is minded to make a residuary gift but no specific gifts to the widow or charity, any business or agricultural property qualifying for relief should be specifically given. The same advice will be given if he is minded to gift property specifically to the widow or charity in addition to the residuary bequest. To that extent, any difference in interpretation is immaterial. So long as residue is given to the widow or charity, chargeable specific gifts should if possible be made out of property qualifying for relief. But once the narrower interpretation is accepted there remains scope for saving by reversing the form which the dispositions take: viz, by making a specific gift of property not qualifying for relief to the widow to a value which avoids the need to gift further property, and by gifting residue including any business and agricultural property qualifying for relief by way of a chargeable transfer