VALUATION FOR THE PURPOSES OF INHERITANCE TAX

LECTURE DELIVERED TO THE
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Simon McKie

MA (Oxon), Barrister, FCA, CTA (Fellow), APFS, TEP

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Rudge Hill House
Rudge
Somersetshire
BA11 2QG

Tel: 01373 830956
Email: simon@mckieandco.com
Website: www.mckieandco.com

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SECTION I

INTRODUCTION

A WORLD OF THE IMAGINATION

1.1.1 Inheritance Tax, under the name of Capital Transfer Tax,[1] was introduced in 1974 by Denis Healey. Although, it was, originally, an elegantly satisfying intellectual construct, it is perhaps unsurprising that a tax introduced by the Chancellor who confidently predicted that the first Gulf War would result in something akin to a worldwide nuclear winter, should operate in a remote world of the imagination. The tax involves determining the consequences of complex layers of competing counterfactual hypotheses.

1.1.2 As we shall see, the provisions relating to valuation are key elements of this shadowy world of the imagination. Because the charge on lifetime transfers for individuals is based on the loss to the transferor, the charge arising on death is based on an hypothetical transfer immediately before death and the charge on settlements is based on an hypothetical transfer by a hypothetical settlor with a hypothetical history of hypothetical previous transfers, the tax requires calculations on occasions when no actual transfers are made or, where there is an actual transfer, by reference not to that actual transaction but to purely hypothetical transactions. That being the case, the charge is mainly calculated by reference to the value of assets rather than the actual terms ruling in actual transactions.

[1] In this lecture references to Inheritance Tax are to be taken to include references to Capital Transfer Tax unless the context indicates otherwise. Inheritance Tax is usually abbreviated to IHT.

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1.1.3 For that reason the Inheritance Tax Act 1984[2] includes a complete part of valuation provisions and in addition, many other provisions affecting valuation.

1.1.4 This lecture explains some of the principal valuation provisions and their application and considers those parts which present problems of construction making reference to many of the major valuation cases in respect of Inheritance Tax and its predecessors.[3]

[2] All references in this lecture are to the Inheritance Tax Act 1984 unless otherwise stated

[3] Valuation of course, is not relevant only to IHT but also to a whole range of taxes including Capital Gains Tax, Income Tax and Stamp Duty Land Tax and of many areas of law outside the Revenue law.

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SECTION II

SECTION 160 – THE PRINCIPAL VALUATION PROVISION

INTRODUCTION

2.1.1 The basic valuation rule is found in s.160 which provides that:

> ‘Except as otherwise provided by this Act, the value at any time of any property shall for the purposes of this Act be the price which the property might reasonably be expected to fetch if sold in the open market at that time; but that price shall not be assumed to be reduced on the ground that the whole property is to be placed on the market at one and the same time.’’

2.1.2 This apparently straightforward provision raises a number of difficult questions of construction. What property is to be valued? What is an open market? Who or what is the vendor that the section assumes? What other steps is the vendor assumed to take? What time period is assumed to apply to those steps? What information is the vendor assumed to make available to potential buyers? Who or what is the buyer? What knowledge is available to the buyer? These questions are examined in the succeeding parts of this Section.

2.1.3 Some light is thrown on some of these questions by decided cases although some only add to the confusion.

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2.1.4 In discussions of Capital Transfer Tax and IHT reference is often made to cases decided in respect of Estate Duty. Commentators often seem to assume that the principles emerging from Estate Duty cases can be applied without qualification to IHT. Mr Justice Lightman warned against this in his decision in the High Court in *Melville and others v IRC*,[4] a decision which was confirmed by the Court of Appeal. He said:[5]

> "It was submitted that I should incline in favour of construing the legislation holding that a general power did constitute "property" because … it was held to constitute property of which the settlor was competent to dispose under the estate duty legislation ...
>
> I reject these arguments. … I do not think that authorities on the estate duty legislation are helpful on the quite different legislation which replaced it.'

2.1.5 Nonetheless, the Courts in considering questions concerning IHT have themselves assumed the continuing relevance of the basic principles of valuation established in a number of leading Estate Duty cases and reference is made to those cases.

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4 *Melville and Others v CIR* CA [2001] STC 1297

5 *Melville and Others v CIR* [2000] STC 628 para 23

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WHAT PROPERTY IS TO BE VALUED?

2.2.1 The first step in any question of valuation for IHT purposes is identifying the property to be valued. Often, that is not straightforward.

The Charge to IHT on Lifetime Transfer

2.2.2 The primary charge to IHT is ‘on the value transferred by a chargeable transfer.[6] A chargeable transfer is a transfer of value made by an individual which is not an exempt transfer.[7] A transfer of value is a disposition made by a person (a transferor) as a the result of which the value of his estate immediately after the disposition is less than it would be but for the disposition; and the amount by which it is less is the value transferred by the transferor.[8]

2.2.3 If we are concerned, therefore, with a lifetime chargeable transfer by an individual we must, in theory at least, value the whole of his estate immediately before the disposition and immediately on the disposition having been made. In the simplest cases, of course, the only effect of a disposition will be the removal of the property which is the subject of the transfer from the transferor’s estate so that in practice it will not be necessary to consider the value of the whole estate. But in many cases this will not be the case.

[6] Section 1
[7] Section 2
[8] Referred to in this lecture as the “loss to the donor principle”.

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Example 2.1

Mr Ashton-Brown owns two acres of industrial land (the "Industrial Site") which has a market value of £1,000,000 and which is let to a company which he owns. The company carries on a trade on the Industrial Site. The shares in the company are worth £2,000,000. He gives one eighth of an acre of this land to his daughter (the "Donated Land"). The Donated Land is a ransom strip as it controls access to the remaining land (the 'Remaining Land'). Without the strip the market value of the Remaining Land is just £600,000 and the value of the shares will be reduced to £1,400,000 because of the resulting uncertainty as to access to the land on which it conducts its trade. The Donated Land has a market value of £250,000 reflecting its 'ransom' value. That ransom value does not equal the aggregate diminution in the value of the shares and Remaining Land which results from the separation of their ownership from the ownership of the Donated Land.

Mr Ashton-Brown's transfer of value is:

	Shares	Land	Total
	£	£	£
Estate before disposition	2,000,000	1,000,000	3,000,000
Estate after disposition	1,400,000	600,000	2,000,000
Transfer of value			£1,000,000

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The Charge to IHT on Termination of an Interest in Possession

2.2.4 If one is dealing with the charge on the termination of certain interests in possession ("IIP") under s.52(1), however, tax is charged as if the holder of the IIP had made a transfer of value and the value transferred had been equal to the value of the property in which his interest subsisted.

2.2.5 If in Example 2.1 the Industrial Site and shares had been owned by a trust under which Mr Ashton-Brown had an IIP within s.52 and the trustees had exercised a power to advance the Donated Land to his daughter, Mr Ashton-Brown would have been treated under s.52(1) as having made a transfer of value but the measure of the transfer of value would have been the market value of the Donated Land; that is, just £250,000.

Charges to IHT on Relevant Property Settlements

2.2.6 The loss to the donor principle applies to the Exit Charge on relevant property settlements under s.65 but by reference to the decrease in the value of the relevant property in the settlement concerned.[9]

Charge to IHT on Death

2.2.7 One also needs to consider carefully the nature of the property to be valued in calculating the charge arising by reason of death. The complex provisions relating to death are considered later.

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[9] Section 65(1)

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Charges on Property

2.2.8 An interesting question is the extent to which charges on assets securing liabilities reduce the value of those assets and how this relates to the deduction of the secured liability. Where the loss to the donor principle applies, it might be thought that the question is unimportant because, if the charge does not reduce the value of the asset itself, the liability will reduce the aggregate value of the estate. The question is important, however because, as we shall see, the provisions governing the valuation of liabilities are of uncertain scope.

2.2.9 Consider the following example.

Example 2.2

The situation

Mr Major dies owning a house with an unencumbered value of £800,000 on which a loan of £300,000, is secured by way of mortgage.

The connundrum

Tax is charged under s.4 as if immediately before his death, Mr Major had made a transfer of value and the value transferred by it had been equal to the value of his estate at that time. In determining the value of Mr Major's estate, what is the effect of the house and the related liability for the loan? Obviously, the expected result is that tax will be charged on a net value of £500,000 being the value of the unencumbered freehold less the amount of the loan. Whether that is the case and, if so, how the

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legislation achieves this is not entirely straightforward.

Taking account of the liability

Under s.160 "… the value at any time of any property … shall be the price which the property might reasonably be expected to fetch if sold in the open market at that time …". At the time the property is to be valued there is a charge upon it securing a loan of £300,000 so one might argue that the value of the property would clearly be less than £800,000.

Section 5(3) provides that in "determining the value of a person's estate at any time his liabilities at that time shall be taken into account, except as otherwise provided by [the Inheritance Tax Act 1984]. It might appear therefore that the charge will affect the value of the house under s.160 and that the liability for the loan will be deducted under s.5(3). If we assume for the moment that the amount to be taken into account in respect of the mortgage loan is £300,000 it would appear, at first, that the value of Mr Major's estate is less than £500,000. Can this be correct?

Can one ignore the encumbrance?

Perhaps one ignores the encumbrance in arriving at the value of the house? It is clear, however, from, for example, *Alexander v IRC*[10] that a charge on a property must be taken into account in valuing that property.

[10] *Alexander v IRC* [1991] STC 112

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Rights of recovery

If the mortgagee were to exercise its charge on the property to satisfy Mr Major's mortgage loan after Mr Major had sold the property, it is likely that the purchaser would have a right to recover the amount retained from the sale proceeds by the mortgagee from Mr Major. So it may well be that the effect of the charge on the property is not to reduce its value by the full amount of the loan. Nonetheless there is all the difference in the world between an unencumbered freehold and one subject to a charge even if, in the event of its exercise, the owner would have a right of recovery against the vendor. That is because, in the latter case, the owner would bear the inconvenience and uncertainty of exercising his right of recovery. So the encumbrance would significantly reduce the price which would be paid for such a property.

The relationship of section 160 and section 162(4)

Section 162(4) provides that 'a liability which is an incumbrance[11] on any property shall, so far as possible, be taken to reduce the value of that property'. So if the loan is an 'incumbrance' on the property by virtue of the charge, it will be taken to reduce the property's value. But that value must first be determined and it is to be determined under s.160. Arguably the s.160 value from which it is deducted will itself take account of the encumbrance.

[11] The legislation uses this rather odd variation on 'encumbrance' although it is not to be found in the SOED.
[12] See para 2.5.7 below

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Does "taken into account" necessarily involve deducting the face value of the liability?

As we have seen, however s.5(3) provides that in determining the value of a person's estate at any time, his liabilities at that time shall be 'taken into account'. That sub-section does not determine how the liabilities are to be taken into account. As we shall see, s.162 does not provide a comprehensive code for determining the amount of a liability that is to be taken into account under s.5(3). Perhaps the answer to the conundrum is that the liability is only to be taken into account to the extent that it does not already reduce the value of the property itself. Nothing in the legislation, however, says so.

Should the charge be treated as being discharged?

The rule that the vendor must be deemed to put the property on the market in the way which will result in the highest price being obtained[12] can surely not be extended so as to deem the property to be treated as sold subject to a condition precedent that the charge be released even though, of course, that is commonly the condition imposed when such properties are actually sold. That would not be to value the property which is deemed to pass under the hypothetical disposition of Mr Major's estate but a different property altogether and is inconsistent with the decision in *Alexander*.

How do we arrive at the practical answer?

In practice, of course, Mr Major's estate would be valued at £500,000 but the route by which that result is reached is not clear.

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Restrictions on Sale

2.2.10 Section 160 asks what price might be obtained for a property 'if [it were] sold in the open market'. What does one do if there are restrictions on the owner's ability to sell in the market?

Re Aschrott, Clifton & Strauss

2.2.11 This was first considered in the Estate Duty case of *Re Aschrott, Clifton & Strauss*[13] The case concerned UK securities which were owned by a German national who was domiciled in Germany during the 1914-1918 War. Under emergency war legislation, the securities were vested in the Custodian of Enemy Property and it was not possible for anybody to sell them. It was held that they were to be valued at the price at which they would be sold, if they were sold, even though such a sale was illegal and, in practice, impossible.

CIR v Crossman

2.2.12 In *CIR v Crossman*[14] the property to be valued was shares in a company the Articles of Association of which imposed restrictions on their transfer, including providing a right of pre-emption in favour of the existing shareholders. The House of Lords held, by a 3:2 majority, that the shares were to be valued on the basis that the pre-emption rights would not apply on the hypothetical sale but that the hypothetical purchaser would acquire them subject to those rights. Thus the value of the shares was not restricted to the sum which could have been obtained if the pre-emption rights were exercised. The pre-emption

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[13] *Re Aschrott, Clifton & Strauss* [1927] 1 Ch 313

[14] *CIR v Crossman; CIR v Paulin,* HL 1936 1 All ER 762

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rights did, however, affect their market value because it would affect the price which the hypothetical purchaser would pay.

2.2.13 At first sight the decision may seem puzzling. After all the existence of pre-emption rights does not prevent a sale from taking place. The rationale of the decision is that one does not merely have to posit a sale at the best price but a sale in the open market and the effect of the pre-emption rights is to prevent a sale in an open market from taking place.

WHAT IS AN OPEN MARKET?

Re Lynall deceased

2.3.1 The leading case on the question of what is an open market is *Re Lynall deceased.*[15] In that case Lord Morris of Borth-y-Gest explained in relation to whether information should be assumed to be available to the buyers of an asset:-

> "… the question arises whether that information would be available not just to some possible purchasers and vendors, but whether it would be available to hypothetical purchasers and vendors 'in the open market.'
>
> This must mean whether it would be openly available to all potential purchasers and vendors in the market or markets in which the relevant purchases and sales take place. There may be different markets or types of markets for differing varieties of property, but in the operation of [the Estate Duty Valuation

[15] *Re Lynall deceased; Lynall and another v Commissioners of Inland Revenue* HL [1971] 3 All ER 914

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> Provisions] the market which must be contemplated, whatever its form, must be an 'open' market in which the property is offered for sale to the world at large so that all potential purchasers have an equal opportunity to make an offer as a result of its being openly known what it is that is being offered for sale. Mere private deals on a confidential basis are not the equivalent of open market transactions."

2.3.2 A sale in the open market, therefore, does not include every possible sale available to the actual owner of the asset or indeed to a hypothetical vendor. It is restricted to offers for sale which are made to the world at large in which all potential purchasers have an equal opportunity to make an offer.

2.3.3 Lord Reid, specifically made this point in commenting:-

> "The [Act Imposing Estate Duty] could have provided – but it did not – that the value should be the highest price that could reasonably have been expected to be realised on a sale of the property at the time of the death. If that had been the test then the Crown would succeed … But the framers of the Act limited the enquiry to one type of sale – sale in the open market."

2.3.4 In *Re Lynall deceased* this had the important consequence that the Court held that conditions which would only apply to offers of an asset to a limited range of purchasers could not be assumed to apply to the hypothetical sale in the open market.

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THE VENDOR

2.4.1 The Vendor is a hypothetical vendor. In *Re Lynall deceased*, Mr Justice Plowman said that it was common ground in the case that the shares to be valued:-

> "must be valued on the basis of a hypothetical sale on [the valuation date] in a hypothetical open market between a hypothetical willing vendor (who would not necessarily be a director [of the company in which the shares subsisted]) and a hypothetical willing purchaser, on the hypothesis that no one is excluded from buying …"

2.4.2 In restoring the High Court's decision, Lord Justice Widgery said in the House of Lords that " it is established that the sale is a wholly hypothetical one conducted between hypothetical parties" and went on to explain that although:-

> "It is desirable … that when the Court is constructing the conditions under which the hypothetical sale is deemed to take place it should build upon a foundation of reality, so far as this is possible … it is even more important that it should not defeat the intention of the section by an undue concern for reality in what is essentially a hypothetical situation."

The hypothetical vendor is deemed to have such information as flows from his ownership of the asset concerned but not information which is available to him from other sources.

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2.4.3 Lord Reid in the same case explained that the hypothetical seller "being a willing seller and an honest man, … would give as much information as he was entitled to give."

The Vendor's Assumed Characteristics

2.4.4 Thus the assumed vendor is:-

(a) not the actual vendor so, although he is assumed to own the asset to be valued, he is not assumed to have the knowledge possessed by the actual owner which is not derived from ownership of the property concerned;

(b) willing to make a sale;

(c) willing to make available as much information as he is entitled to give so as to obtain the best price;

(d) an honest man so that he will neither mislead the buyer nor disclose information which he is not entitled to disclose.

2.4.5 Under (a), one must bear in mind the importance of identifying the property to be valued. When the loss to the donor principle applies, it is the transferor's whole estate before and after the relevant disposition which is to be valued. Therefore, any information which is available to an owner of any of the assets in the estate of the owner is to be assumed to be known to the hypothetical vendor.

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WHAT STEPS IS THE VENDOR ASSUMED TO TAKE IN ORDER TO FACILITATE THE SALE AND WHAT TIME PERIOD IS ASSUMED TO APPLY TO THOSE STEPS?

Earl of Ellesmere v CIR

2.5.1 In the Estate Duty case of *Earl of Ellesmere v CIR*[16], the Executors of the deceased sold an estate of 2,300 acres for £68,000. The estate comprised several lots, including almshouses, shops, business premises and woodlands and it was sold in one lot after being well advertised. The purchaser immediately resold most of the estate for £65,000 and retained items worth £16,000 thus giving it an aggregate value of £81,000. An Estate Duty Referee valued the estate at approximately £76,000 and the High Court rejected the Executors' appeal on the basis that the Referee had been entitled to hold that because the property was of a "miscellaneous character and not lying in a ring fence, the price paid by the single purchaser was not the true value."

2.5.2 This decision is authority for the proposition that if the property to be valued would raise a higher aggregate price if divided into lots, the hypothetical sale is to be treated as a sale of individual lots.

2.5.3 That principle, however, raises two further questions. First, how do you deal with sales where dividing the property and marketing the lots will take considerably greater time than selling the property as a single unit? Secondly, how do you deal with situations where the lots would have realised a higher value if sold at separate times than if they

[16] *Earl of Ellesmere v CIR,* KB [1918] 2 KB 765

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were all put on the market at the same time? That is, if how does one deal with situations where flooding the market with similar assets will reduce their aggregate value?

Duke of Buccleuch and another v CIR

2.5.4 Those questions were considered by the House of Lords in *Duke Buccleuch and another v CIR*[17] which concerned an appeal against the Inland Revenue's valuation of the deceased's estate (which consisted of a large mixed landed estate) which was based on dividing it into 532 natural units. The Trustees argued that only 46 of these units could be sold individually within a reasonable time and that the remaining 486 could only have been sold without unreasonable delay if they were sold as a whole to an investor or speculator and that, in that case, the price obtained would be some 20% less than the aggregate valuation of the individual units. The House of Lords rejected the Executors' appeal. Lord Reid said that:-

> "The fact that it would have taken a long time to sell separately the units of a large estate is irrelevant insofar as that delay would have been caused by the need to avoid flooding the market."

2.5.5 This principle has been given statutory form in the proviso to s.160:-

> "…but that price shall not be assumed to be reduced on the ground that the whole property is to be placed on the market at one and the same time."

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[17] *Duke of Buccleuch and another v CIR* HL [1967] 1 All ER 129

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2.5.6 At this point one seems to have lost all touch with reality in performing the valuation exercise. Lord Reid went on to say, however:-

> "Generally the estate will consist of what one may call natural units —units or parcels of property which can be easily identified without there being any substantial difficulty or expense in carving them out of the whole estate. In my opinion, it is implicit in the scheme of the Act that [the valuation section for estate duty] should be applied to each of such units, and there is no justification for requiring elaborate subdivision of natural units on the ground that if that had been done before the hypothetical sale the total price for the natural unit would have been increased."

2.5.7 The gloss put on this by the Court of Appeal in *Gray and Others v IRC*[18], however, is simply that although the vendor is to be assumed to have done whatever would have produced the highest price he is not presumed to have undertaken any actions which would involve an undue expenditure of time and effort.

WHAT INFORMATION IS THE VENDOR ASSUMED TO MAKE AVAILABLE TO A POTENTIAL BUYER

2.6.1 It follows from the nature of the hypothetical seller that he will make available any information which is in his possession relevant to the decision to purchase the property.

[18] *Gray and Others (Lady Fox's Executors) v IRC*, CD [1994] STC 360

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2.6.2 Because he is assumed to want to obtain the highest possible price available in the open market he will make available all information which supports a higher value for the property. Because he is assumed to be an honest man he will not falsify or hide unfavourable information. As we have seen, however, the information which he has available to him will be restricted to the information which is available to him by virtue of his ownership or which he could reasonably obtain by reason of his ownership.

THE BUYER

2.7.1 As we have seen, the buyer similarly is an hypothetical person buying in the open market with such knowledge as is available generally to those buying in such a market.

Special Purchasers

CIR v Clay

2.7.2 In the Estate Duty case of *CIR v Clay*,[19] the deceased owned a house worth £750 as his residence. The house adjoined a nursing home and the trustees of the home wished to extend their premises. For that reason they were prepared to pay more for the house than what would otherwise have been the market price. The Court of Appeal held that the open market value was £1,000. The then Master of the Rolls, Lord Cozens-Hardy, said:-

> "I can see no grounds for excluding from consideration the fact that the property is so situate that to one or more persons it presents greater attractions than to anybody else …"

[19] *CIR v Clay; CIR v Buchanan* CA [1914] 3KB 466

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2.7.3 This established for Estate Duty purposes a principle, which has been followed in Inheritance Tax, that the hypothetical market includes all actual possible buyers and therefore that it is appropriate to take into account, in the words of the Master of the Rolls, the presence in the hypothetical open market of an actual purchaser to whom the property to be valued 'presents greater attractions than to anybody else'; that is of a "Special Purchaser".

What is the effect of the presence of a Special Purchaser?

2.7.4 The question is, what is the significance of there being a Special Purchaser in the market? In *Clay*, the Master of the Rolls seems to have assumed that the result was that the property would have been sold to the trustees for the maximum amount which they were willing to pay. One might have expected, however, that the price negotiated would have been somewhere between the next best price available to the vendor and that maximum. Indeed, if one follows the logic of the decision in *Bower,*[20] one might argue that, as s.160 requires one to posit a sale in the open market whether or not the actual owner would be willing to make such a sale, a buyer would be willing to pay no more than the price which he estimated as being slightly above the price which any other buyer would pay. On the basis of the facts in *Clay*, that would be a little over £750.

2.7.5 In their Inheritance Tax Manual HMRC accept that in valuing property one must take account of the presence in the hypothetical market of a special buyer but that, even where

[20] *HMRC v Bower & Chesterfield (Mrs Bower's Executors)* Ch D [2009] STC 510

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one does so, the effect will be that "the market value will be less than what [sic] the special buyer is prepared to pay."[21]

WHAT INFORMATION IS AVAILABLE TO THE BUYER?

The Basic Rule

2.8.1 Lord Widgery explained in *Re Lynall deceased*:-

> "… whatever the nature of the property in question, it must be assumed that the purchaser would make all reasonable enquiries, from all available sources, which a prudent purchaser of that property would wish to make, and it must further be assumed that he would receive true and factual answers to all such enquiries."

2.8.2 This, however, is subject to the limitation that the purchaser is to be considered to be a purchaser in an open market so that the hypothetical purchaser will not be deemed to make any enquiries which it would only be reasonable to expect him to make in the course of negotiations for a sale by private treaty.

S. 168 - Unquoted Shares and Securities

2.8.3 This is subject, in respect of unquoted shares and securities, to the provisions of s.168 which are as follows:-

[21] IHTM para 9704

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> "In determining the price which unquoted shares or unquoted securities might reasonably be expected to fetch if sold in the open market it shall be assumed that in that market there is available to any prospective purchaser of the shares or securities all the information which a prudent prospective purchaser might reasonably require if he were proposing to purchase them from a willing vendor by private treaty and at arm's length."

Publicly available information

2.8.4 Because the buyer is assumed to be a prudent man, he will make use of whatever information would be available to a member of the public, buying in an open market. He would, therefore, take due account of all publicly available information which could be accessed without a disproportionate expenditure of effort. He will not, however, be deemed to have access to information which is available only to those buying privately.

How does the limitation to publicly available information relate to a Special Purchaser?

2.8.5 A question which presents itself is how this limitation can apply to the Special Purchaser? The two principles can be reconciled by regarding the Special Purchaser as being able to use the property in a way which enhances its value to him but only such knowledge of the property as is available to the public generally. Thus the fact that because a piece of land adjoins land on which mineral extraction takes place and would be useful to the owner of that other land to improve the owner's access to the mineral site will make the other land owner a Special Purchaser and will enhance the value of the land to be valued in the hypothetical sale. The fact that a particular buyer happens to know that, unbeknown to its owner, the land to be valued contains minerals, will not.

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SECTION III

DEATH

THE CHARGE ON DEATH

3.1.1 We have already looked briefly at the charge which arises on death.

> "On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death. [22]

VALUATION ON DEATH

3.2.1 Section 171 provides that:-

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

[22] Section 4

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alteration as is mentioned in section 98(1) above [alterations of capital etc. of a close company]; but the termination on the death of any interest or the passing of any interest by survivorship does not fall within this subsection."

3.2.2 It would obviously be unjust to charge IHT on value which is destroyed by the death of the individual concerned. For example, if a professional services company's goodwill is almost entirely dependent upon the continuing services of the controlling director, it would be unfair to charge IHT without regard to the fall in the company's value which would occur by reason of the director's death. Section 171 prevents that result.

Interests Coming to an End on Death

3.2.3 The proviso in sub-section (2) is designed to ensure that interests which determine on death in property which is not itself extinguished by the death will be charged to IHT. Otherwise, substantial property could be transferred from one person to another without a charge arising.

3.2.4

Example 3.1

Harry Masters-Jersey and his son William are joint tenants of a large commercial property. On Harry's death, William's interest is increased, by survivorship, from a joint interest to an absolute interest in the whole and Harry's interest comes to an end. If it were not for the proviso to sub-section (2), Harry's interest in the industrial estate would

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be valued at nothing because, arguably, the value of his interest has decreased to nil by reason of its extinction.[23]

Because of sub-section (2) the value of Harry's estate immediately before his death for the purposes of s.4 will include the value of his joint interest in the property which will be valued without reference to his death.

3.2.5 Even where the proviso to sub-section (2) applies, however, it will not necessarily follow that the value of the property concerned is unaffected by the death of the owner.

3.2.6 An obvious example is an annuity. An annuity on the life of a person will have a capital value which will be based on the amount of the annuity payments, prevailing market rates of interest and the estimated date of the annuitant's death. When the annuitant dies his interest will come to an end. Because of the proviso in sub-section (2), in valuing the right to the annuity on his death, one cannot take into account the coming to an end of his interest on that death.

3.2.7 One still has to ask what price would be paid in the market for an annuity on the life of that particular annuitant immediately before his death, remembering that the hypothetical purchaser is deemed to obtain all such information as a reasonably prudent purchaser would be expected to obtain in the circumstances and the price is not to be affected by the

[23] The alternative argument is that its value has not decreased at all but rather that because, on Harry's death, his interest simply ceases to be it no longer has any attributes

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need to make a quick sale. A prudent purchaser of an annuity would make enquiries as to the current health and condition of the annuitant.

3.2.8 Immediately before a person's death it is normally predictable that he is going to die. For example, where a person dies of a terminal illness such as cancer it is normally predictable immediately before their death that they will die very shortly. People often die unexpectedly of course, from heart attacks for example, but a reasonably prudent purchaser considering purchasing a substantial annuity is likely to require medical evidence of the health of the annuitant which is likely to reveal the probability of an early death. Even in an accident, it is normally predictable, immediately before the accident that the accident is about to take place. Consider, for example, the moment before two cars crash head-on on a motorway.

FUNERAL EXPENSES

3.3.1 Section 172 provides that:-

> "In determining the value of a person's estate immediately before his death, allowance shall be made for reasonable funeral expenses."

3.3.2 This is a relief derived from Estate Duty which has a long history. HMRC's Inheritance Tax Manual used to say that the reasonableness of funeral expenses is to be judged in the light of the former station in life of the person who has died, his creed and racial origin but this comment has now been amended to "you should take account of

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the deceased's background and profession".[24] There have been a number of changes to HMRC's practice in recent years. With effect from 9th December 2009 they will no longer allow a reasonable amount for mourning apparel for the family and servants although in Scotland alone, based on the decision in *IRC v Alexander's Trustees*[25] mourning for a widow does constitute a proper funeral expense. HMRC will now regard the cost of a tombstone or gravestone as part of reasonable funeral expenses although they will not accept the cost of a memorial such as a plaque inside a Church or a memorial monument although there is some ambiguity in the IHT Manual as to that.[26]

EXPENSES INCURRED ABROAD

3.4.1 Section 173 provides that:-

> "In determining the value of a person's estate immediately before his death, an allowance against the value of property situated outside the United Kingdom shall be made for any expense incurred in administering or realising the property which is shown to be attributable to the situation of the property, but the allowance shall not exceed 5 per cent of the value of the property."

3.4.2 This is a restrictive relief. As can be seen from the above, it only applies to the excess of the expenditure over and above what it would have cost to deal with similar property in the UK and it is limited to five per cent of the value of the asset concerned regardless of the actual amount of the expense. It should also be noted that the expense has to be

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[24] Simon's Taxes para 14.142 and IHTM 10373

[25] *IRC v Alexander's Trustees* [1985] 7 F 367

[26] Statement of Practice SP 7/87 and IHT Manual Para IHTM 10373

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actually incurred. With assets of small value in overseas jurisdictions it is sometimes not worthwhile for executors to prove ownership of the asset because the expenses of doing so will exceed the value of the asset. Nonetheless, the asset will form part of the deceased's estate immediately before death, it will be valued, without regard to sale expenses, on the basis of a sale in the open market under s.160 and relief under s.173 will be restricted to 5% of that value and will only be available if the expense is actually incurred. If the expense is not incurred because it is disproportionate to the value of the asset, IHT will be charged on the full value of the asset.

INCOME TAX AND UNPAID INHERITANCE TAX

3.5.1 On the death of a person, any accrued offshore income gains are brought into charge as are certain deep discounts on deep discount securities. Because that charge arises on death and not immediately before the death the resulting liability for Income Tax would not be deductible in arriving at the charge on death under s.4(1) were it not that s.174(1) provides relief.

3.5.2 Section 174(2) provides that where in determining the value of a person's estate immediately before death a liability to Capital Transfer Tax or IHT is taken into account but in the event the liability is not paid from the estate then the estate is deemed to be increased by the amount which is not so paid. This might, happen for example, where a potentially exempt transfer proves to be chargeable because death occurs within seven years of the transfer but the tax is paid by the donee.

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LIABILITY TO MAKE FURTHER PAYMENTS

3.6.1 Section 175 makes special provision in relation to a liability to make future payments in respect of disposition within s.262.

SCOTTISH AGRICULTURAL LEASES

3.7.1 Section 177 includes particular provisions relating to Scottish agricultural leases.

WHY DO EXEMPTIONS APPLY ON DEATH?

3.8.1 It is generally accepted in practice that in respect of the charge on death, those reliefs are given which would apply if the actual devolution of the estate on death were a chargeable transfer. For example, if a husband leaves all of his property by will to his spouse, it is accepted that the disposition which is deemed to arise on death under s.4(1) is an exempt, inter-spouse transfer under s.18.

3.8.2 Why is this? IHT is charged under s.4(1) "…as if immediately before …[the]…death, …[the deceased]…had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death." Now notice that this transfer of value is purely hypothetical. It is not the actual devolution of the estate which occurs under the deceased's will or intestacy and there is no statutory mechanism to impose the provisions of that will or the intestacy rules on the hypothetical transfer.

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3.8.3 It is true that section 3(4) ensures that any provision in the Inheritance Tax Act referring to a transfer of value can refer to the occasion of a charge under s.4(1) so that these provisions are to be construed so as to treat the deceased as the transferor. What s.3(4) does not do is attribute the provisions of the deceased's will or intestacy to the deemed transfer of value.

3.8.4 So why isn't IHT charged on death without the application of any of the exempt transfer provisions?

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SECTION IV

SPECIAL RELIEFS FOR POST-DEATH DISPOSALS

INTRODUCTION

4.1.1 Sections 176 and 178 – 198 contain three particular reliefs where certain sorts of property contained in a person's estate immediately before his death are sold within a limited period after the death.

SECTION 176: RELATED PROPERTY ETC

4.2.1 Relief can be claimed under s.176 where within three years after the death there is a qualifying sale of any property comprised in a deceased's estate immediately before his death where the property was valued for the purposes of the Inheritance Tax Act in accordance with the related property rules or in conjunction with property which was also comprised in the estate but which has not at any times been vested in the vendor. Where the relief applies, the value of the property concerned immediately before the death is to be taken to be what it would have been had it not been determined under the related property laws or in conjunction with the other property.

4.2.2 The relief contains rules to deny relief to artificial sales. The relief does not apply unless the price obtained on the sale is less than the value originally taken into account for IHT.

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THE SALE OF QUOTED SHARES AND SECURITIES AND OF LAND FROM THE DECEASED'S ESTATE

4.3.1 Two separate but similar reliefs are given in respect of sales of quoted shares and securities and of land. The relief for quoted shares and securities is given by ss.178-189 and that for land by ss.190-198.

4.3.2 The reliefs require a claim by 'the appropriate person'. That is the person who is liable for the IHT attributable to the value of the property concerned or, if there is more than one such a person, and one of them in fact pays the tax, that person. That means that if there is no tax payable on the property concerned a claim cannot be made.

4.3.3 One may ask why one would want to make a claim which would have the result of increasing the value of the property for the purpose of the IHT charge on death. The answer is that if the value of the property falls within the nil-rate band, an increase in its deemed value for the purposes of s.4(1) will not give rise to an IHT charge. The increased value, however, would be the base cost of the asset on the sale for the purposes of Capital Gains Tax because of the provisions of TCGA 1992 s.274. The Executors in the case of *Stonor v Mills (Dickinson's Executors) v CIR*[27] tried, unsuccessfully, to make just such a claim.

[27] *Stonor v Mills (Dickinson's Executors) v CIR* SpC [2001] SSCD 199

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SECTION V

RELATED PROPERTY

THE RULES

5.1.1 The main related property rule is given in section 161(1) and (2):-

> "(1) Where the value of any property comprised in a person's estate would be less than the appropriate portion of the value of the aggregate of that and any related property, it shall be the appropriate portion of the value of that aggregate.
>
> (2) For the purposes of this section, property is related to the property comprised in a person's estate if –
>
> (a) it is comprised in the estate of his spouse or civil partner[3]; or
>
> (b) it is or has within the preceding five years been –
>
> (i) the property of a charity, or held on trust for charitable purposes only, or
>
> (ii) the property of a body mentioned in section 24, 24A,[1] or 25[2] above,
>
> and became so on a transfer of value which was made by him or his spouse or civil partner[3] after 15th April 1976 and was exempt to the extent that the value transferred was attributable to the property."

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APPORTIONMENT

5.2.1 The method of apportioning value where the related property rules apply is then given in sub-sections (3) to (5) ibid:-

> "(3) The appropriate portion of the value of the aggregate mentioned in subsection (1) above is such portion thereof as would be attributable to the value of the first-mentioned property if the value of that aggregate were equal to the sums of the values of that and any related property, the value of each property being determined as if it did not form part of that aggregate.
>
> (4) For the purposes of subsection (3) above the proportion which the value of a smaller number of shares of any class bears to the value of a greater number shall be taken to be that which the smaller number bears to the greater; and similarly with stock, debentures and units of any other description of property.
>
> (5) Shares shall not be treated for the purposes of subsection (4) above as being of the same class unless they are so treated by the practice of a recognised stock exchange or would be so treated if dealt with on such a stock exchange."

5.2.2 It will be noticed that where the asset to be valued in conjunction with related property is shares, the apportionment is made on the basis of the number of shares held. Where

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other property is to be valued, the apportionment is to be made on the basis of the values which would apply if the property were not related property.

THE PURPOSE OF THE PROVISIONS

5.3.1 Because of the loss of the donor principle it would have been possible, by a judicious use of exempt transfers, to engineer a series of exempt and chargeable gifts in which a disproportionate amount of the value of the whole would pass under the exempt gifts. The related property provisions are designed to prevent this.

AN EXAMPLE

5.4.1

Example 5.1

Mr Keeve owns the entire issued share capital of Wassail Ltd being 100 £1 ordinary shares.

He makes the following gifts:-

Day	Gifts to his son	Gifts to a charity
1	24 shares	-
2	-	2 shares
3	23 shares	-
4	-	2 shares
5	49 shares	-

The values at all times of various sizes of shareholding in the company are:-

Shareholding	Value per share £'000	Value of shareholding £'000
100	100	10,000
96	98	9,408
76	95	7,220

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74	75	5,550
53	75	3,975
51	75	3,825
49	30	1,470
4	20	80
2	20	40

If the Related Property Rules had not applied, Mr Keeve's Transfers of Value would have been:-

Day	**Holding before transfer**	**Holding after transfer**	**Gift**	**Estate before transfer £'000**	**Estate after transfer £'000**	**TOV £'000**
1	100	76	24	10,000 100/100 of 100%	7,220 76/76 of 76%	2,780
2	76	74	2	7,220 76/76 of 76%	5,550 74/74 of 74%	1,670 (exempt under s.23)
3	74	51	23	5,550 74/74 of 74%	3,825 51/51 of 51%	1,725
4	51	49	2	3,825 51/51 of 51%	1,470 49/49 of 49%	2,355 (exempt under s.23)
5	49	0	49	1,470 49/49 of 49%	0 0/0 of 0%	1,470

Mr Keeve would have made exempt charitable transfers of £4,025,000 even though the four shares actually received by the charity were worth only £80,000.

Because the Related Property Rules applied, however, Mr Keeve's actual transfers of value were:-

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Day	Holding before transfer	Holding after transfer	Gift	Estate before transfer £'000	Estate after transfer £'000	TOV £'000
1	100	76	24	10,000 100/100 of 100%	7,220 76/76 of 76%	2,780
2	76	74	2	7,220 76/76 of 76%	7,030 74/76 of 76%	190 (exempt under s.23)
3	74	51	23	7,030 74/76 of 76%	3,825 51/53 of 53%	3,205
4	51	49	2	3,825 51/53 of 53%	3,675 49/53 of 53%	150 (exempt under s.23)
5	49	0	49	3,675 49/53 of 53%	0	3,675

The Exempt transfers are only £340,000.

Notice that the order in which gifts are made is still of importance. Had Mr Keeve made his gifts to the charity first, the amount of the total exempt transfers would have been £400,000 (4/100 of a 100% holding of £10,000,000). If he had made them last they would have been £300,000 (4/53 of a 53% holding).

EXCLUDED PROPERTY

5.5.1 There is a trap in the interaction between the related property and excluded property provisions. The provisions of ss.3 and 5 in respect of excluded property which, loosely, prevent a charge to IHT being made on excluded property apply only to property in a person's estate and do not apply to related property.

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Example 5.2

Mr Brown is domiciled in Scotland and is married to Claudette who is domiciled in France. He owns forty nine per cent of a French investment company, FrenchCo, Claudette owns the other fifty one per cent. Shareholdings in FrenchCo have the following values:-

	£
100% holding	10,000,000
51% holding	4,000,000
49% holding	1,960,000

If Mr Brown were to die his shareholding would be valued at forty nine per cent of the value of a 100% holding; that is £4,900,000. This is so even though Claudette's shareholding is excluded property in her hands.

If before Mr Brown's death, Claudette had settled the shares on trusts of which she was a beneficiary, Mr Brown's shares would be valued at 100 per cent of the value of a 49% holding being £1,960,000.

Notice this is a piece of what is known as "death bed planning" i.e. a tax planning step which can be taken when it is expected that a person will die shortly.

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AT WHAT TIME ARE THE PROVISIONS OF S.161(2) TO BE TESTED?

5.6.1 It is clear that in determining whether a person is a spouse or civil partner of a person whose property is to be valued for the purposes of s.161(2)(a) one looks at the time of valuation.

5.6.2 HMRC's view is that 'for the purpose of transfers to a charity or one of the other bodies listed [in s.161(2)(b)], whether a particular person is another's spouse or civil partner depends on that person's status at the date of the transfer that is being valued and not the earlier exempt transfer'.[28] That is probably a correct construction but there have been no decided cases on the matter and so it remains uncertain. If HMRC are correct, then the provision creates both a planning opportunity and a trap as the following example illustrates:-

Example 5.3

A company's share capital is owned as follows:-

Shareholder	No of Shares
Mr Dabinett	49
Susan Dabinett	4
Charlotte Somerset-Redstreak	6
Charity A	4
Charity B	6

[28] IHTM para 9733

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George Dabinett	31
	100

Mr Dabinett is about to divorce his wife, Susan, and expects thereafter to marry Charlotte. Charity A received its shareholding as a donation from Susan. Charity B received its shares as a donation from Charlotte. The value per share as part of a holding of 25% – 49% is £100,000. The value per share as part of a holding of 51% – 74% is £300,000.

Mr Dabinett wishes to give his shareholding to his son George and is considering making a gift:-

(a) immediately;

(b) after divorcing Susan but before marrying Charlotte;

(c) having married Charlotte.

Under (a) both Susan's shareholding and, on HMRC's interpretation of s.161(2)(b)(ii), Charity A's shareholding will be related property. Mr Dabinett's transfer of value would be of an amount equal to 49/57 of the value of a 57% holding; that is £14,700,000. Under (c), Susan's holding and that of Charity A would no longer be related property but Charlotte's holding and the holding of Charity B would be related property and therefore Mr Dabinett would be deemed to make a transfer of value equal to 49/61 of the value of a 61% holding. Once again that would be £14,700,000. Under

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(b), however, none of the other shareholdings would be related property and so Mr A would be deemed to make a transfer of value equal to 49/49 of the value of a 49% holding; that is £4,900,000.

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SECTION VI

LIABILITIES

INTRODUCTION

6.1.1 Section 5(3) – (5) provides that:-

> "(3) In determining the value of a person's estate at any time his liabilities at that time shall be taken into account, except as otherwise provided by this Act.
>
> (4) The liabilities to be taken into account in determining the value of a transferor's estate immediately after a transfer of value include his liability for capital transfer tax on the value transferred but not his liability (if any) for any other tax or duty resulting from the transfer.
>
> (5) Except in the case of a liability imposed by law, a liability incurred by a transferor shall be taken into account only to the extent that it was incurred for a consideration in money or money's worth."

WHAT IS A 'LIABILITY'?

6.2.1 'Liability' is not defined in the statute and in the absence of a statutory definition we must have recourse to ordinary English usage. The SOED includes a number of definitions of liability. Most apposite are 'a thing for which a person is liable; esp. in pl, the debts or pecuniary obligations of a person or company,' and, as a specifically legal definition 'the condition of being liable or answerable in law or equity.'

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6.2.2 In practice it is accepted that the liabilities to be taken into account for IHT extend beyond merely pecuniary liabilities. Were that not the case then, for example, an estate which was subject to an obligation under a futures contract to supply a security at a future date would receive no deduction for what could be an onerous obligation. It is also clear that vested liabilities to make future payments are deductible because s.162(2) makes specific provision in relation to them. HMRC accept that a contingent liability can also be taken into account and they say that it is to be taken into account at valuation. Although that is a sensible and pragmatic position the authority for it is unclear.

HOW ARE LIABILITIES "TAKEN INTO ACCOUNT"?

6.3.1 How are the liabilities to be "taken into account"? In every day English usage the phrase "to be taken into account" has both a wider and a narrower meaning. Its narrower meaning is the inclusion of a figure in a set of accounts. Its wider meaning, no doubt deriving from a metaphor drawn from the narrower meaning, is to be recognised or considered in a review, consideration or assessment of a matter.

6.3.2 That does not take us very far. It provides no guidance as to how the liability is to be taken into account.

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LIABILITIES NOT INCURRED FOR CONSIDERATION

6.4.1 The provisions of sub-section (5) are important. They are plainly designed to frustrate the following simple tax planning technique.

Example
Mr Nehou enters into a deed promising to pay to his son, £1,000,000 in twenty years time. Mr Nehou dies fifteen years later owing his son £1,000,000. Were it not for sub-section (5) Mr Nehou would have reduced his estate by £1,000,000 by reason of the promise under deed but would not have made any actual payment during his lifetime. Sub-section (5) applies to prevent the liability from being taken into account.

VALUATION OF LIABILITIES

6.5.1 Section 162 provides that:-

(1) A liability in respect of which there is a right to reimbursement shall be taken into account only to the extent (if any) that reimbursement cannot reasonably be expected to be obtained.

(2) Subject to subsection (3) below, where a liability falls to be discharged after the time at which it is to be taken into account it shall be valued as at the time at which it is to be taken into account.

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(3) In determining the value of a transferor's estate immediately after a transfer of value, his liability for capital transfer tax shall be computed -

(a) without making any allowance for the fact that the tax will not be due immediately, and

(b) as if any tax recovered otherwise than from the transferor (or a person liable for it under section 203(1) below) were paid in discharge of a liability in respect of which the transferor had a right to reimbursement.

(4) A liability which is an incumbrance on any property shall, so far as possible, be taken to reduce the value of that property.

(5) Where a liability taken into account is a liability to a person resident outside the United Kingdom which neither -

(a) falls to be discharged in the United Kingdom, nor

(b) is an incumbrance on property in the United Kingdom,

it shall, so far as possible, be taken to reduce the value of property outside the United Kingdom."

6.5.2 The section does not say whether a liability which falls to be discharged at the time it is to be taken into account is to be taken into account at face value or at some sort of valuation. In respect of liabilities which fall to be discharged after the time they are to be taken into account or indeed in respect of any other liabilities which are to be valued, it does not say how that valuation is to be determined.

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6.5.3 Section 160 does not apply because a liability is not property. Even if, by analogy, one assumes that a liability is to be valued by reference to an open market in borrowing what assumptions does one apply in determining the hypothetical borrowing? There is no body of case law from which to do so as there is in respect of valuing property.

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SECTION VII

OTHER MISCELLANEOUS PROVISIONS

RESTRICTION ON FREEDOM TO DISPOSE

7.1.1 Section 163 provides that:-

"(1) Where, by a contract made at any time, the right to dispose of any property has been excluded or restricted, then, in determining the value of the property for the purpose of the first relevant event happening after that time -

(a) the exclusion or restriction shall be taken into account only to the extent (if any) that consideration in money or money's worth was given for it, but

(b) if the contract was a chargeable transfer or was part of associated operations which together were a chargeable transfer, an allowance shall be made for the value transferred thereby (calculated as if no tax had been chargeable on it) or for so much of the value transferred as is attributable to the exclusion or restriction.

(2) Where the contract was made before 27th March 1974 subsection (1) above applies only if the first relevant event is a transfer made on death.

(3) In this section "relevant event", in relation to any property, means -

(a) a chargeable transfer in the case of which the whole or part of the value transferred is attributable to the value of the property; and

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(b) anything which would be such a chargeable transfer but for this section."

7.1.2 The provision seems to be designed to frustrate planning of the following sort:-

Example 7.1

Mr Quinic grants, by deed, to his son, Malic, a call option over some land to purchase the land for £100,000 together with an undertaking not to sell the land to any other person during the duration of the option. Malic protects his rights under the deed by registering the restriction on the Charges Register. The value of the unencumbered freehold is £1,000,000. If it were not for s. 163, the land would be valued under s.160 on the basis that it was possible to sell the asset on the open market but that the purchaser would acquire the asset subject to Malic's rights. Because of s.163, the restriction is ignored and the land is valued at its unencumbered value.

IHT AND CAPITAL GAINS

7.2.1 Section 165 deals with the interaction of IHT, Capital Gains Tax and Income Tax. It provides that where a chargeable transfer includes the disposal of an asset on which a gain accrues to the transferor under the Taxation of Chargeable Gains Act then if any part of the gains are a chargeable gain or a development gain and any Capital Gains Tax or Income Tax charged on the gain is born by the donee, the amount of the tax so borne is

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treated as reducing the value transferred by the chargeable transfer. Similar provisions are made in respect of exit charges on relevant property.

CREDITOR'S RIGHTS

7.3.1 Section 166 provides:-

> "In determining the value of a right to receive a sum due under any obligation it shall be assumed that the obligation will be duly discharged, except if or to the extent that recovery of the sum is impossible or not reasonably practicable and has not become so by any act or omission of the person to whom the sum is due."

7.3.2 The section is a restrictive one which can lead to harsh results because it is an all or nothing provision which displaces the general rule under s.160.

Example 7.1

Mr Pomace dies leaving a debt due from the Industrial Cider Corporation Plc. Immediately before Mr Pomace's death, rumours concerning the company's solvency were rife and, it subsequently emerged that at that point it had assets sufficient only to repay 50p in the £1 to its creditors. That did not become apparent to the public until six months later when it went into a creditor's liquidation by which time the company's position had worsened considerably and creditors were paid out at the rate of 1p in the £1.

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Had the debt been called in immediately before Mr Pomace's death it would have been paid in full because, although the company's assets were insufficient to repay all of the creditors, any individual creditor who had demanded repayment at that time could have been repaid. It is unlikely that the market value of the debt will have been 100% of its face value at that time but s. 166 does not deal with market value. It asks merely whether it would have been impossible or not reasonably practical for the sum concerned to have been recovered at the valuation date and, in respect of Mr Pomace's debt due from the company, that condition was not satisfied.

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SECTION VIII

SPECIAL ASSETS EXCLUDING INSURANCE POLICIES

UNDIVIDED SHARES IN LAND

8.1.1 The valuation of undivided shares in land has very much exercised the Courts both under Estate Duty and IHT. An examination of a selection of these cases elicits the relevant principles.

Cust v IRC[29]

8.1.2 The deceased died holding a 50% interest as tenants in common in freehold properties in London (the "London Properties") and elsewhere in the UK (the "Other Properties"). The Court confirmed the Revenue's valuation of the London Properties as being 95% of half of the value of the unencumbered freehold and of the Other Properties as being 90% of half of the value of the unencumbered freehold.

Wight and Moss v CIR[30]

8.1.3 In this Capital Transfer Tax case, the deceased, a woman, had lived together with a friend in a house which they owned as tenants in common in equal shares. The case concerned the value of the deceased's half share in the house. The District Valuer had proceeded by determining the vacant possession value of the property and deducting from one half of

[29] *Cust v IRC* [1917] 91 Estates Gazette 11
[30] *Wight and Moss v CIR* [1982] 264 Estates Gazette 925

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that value an amount of 10% on the basis of the decision in *Cust v IRC.* The Executors argued that the valuation should be arrived at by capitalising the net rental which could have been obtained by letting the property. The Lands Tribunal found that the vacant possession basis was to be preferred. The Tribunal further found that in the circumstances of the case the Court would probably not order a sale until the death of the other tenant in common of the house but also found that the other tenant should be regarded as a Special Purchaser. Putting these findings together, the Tribunal valued the interest by applying a 15% discount to one half of the vacant possession value.

8.1.4 HMRC regards the Tribunal's decision that the other tenant in common was a Special Purchaser as incorrect in the light of *Walton (Walton's Executors) v CIR*.[31]

St Clair-Ford (Youlden's Executors) v Twiddy[32]

8.1.5 This case involved the valuation for IHT purposes of a half share in a freehold interest in a shop, in a Devon market town, which was let to a well-known retailer. The District Valuer valued the property by taking 50% of the vacant possession value and reducing that amount by 10% whilst the Executors argued for a 15% discount. The Tribunal Member said:-

> 'I am satisfied on the evidence that 10% is indeed the customary discount applied to half shares particularly when they are undivided and there is no likelihood that the surviving partner will remain in occupation (as in a residential property with

[31] *Walton (Walton's Executors) v CIR* CA [1996] STC 68
[32] *St Clair-Ford (Youlden's Executor) v Twiddy*, Lands Tribunal 22nd June 2006 unreported

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tenants in common). There is evidence to suggest higher discounts for minority shares and where there may be other complications, but in the circumstance of this case I have not been taken to any authority which suggest a departure from convention would be appropriate."

8.1.6 This is surely to confuse the legal principles applicable to valuations which are to be taken from decided cases with the facts which provide the evidential base for deciding what discount an hypothetical market would apply to such interests. Valuations of undivided shares in land tend to move between a narrow range of accepted discounts but one would expect actual discounts to vary considerably from the discounts which happen to apply to particular properties valued at particular times in the relatively small number of decided cases.

LEASES FOR LIFE

8.2.1 Section 170 provides that:-

> "Where under section 43(3) above a lease of property is to be treated as a settlement, the value of the lessor's interest in the property shall be taken to be such part of the value of the property as bears to it the same proportion as the value of the consideration, at the time the lease was granted, bore to what would then have been the value of a full consideration in money or money's worth."

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8.2.2 Section 43 will apply where a lease of property is for life or lives, or for a period ascertainable only by reference to death, or which is terminable on, or at a date ascertainable only by reference to, a death and a lease is not granted for full consideration.

FARM COTTAGES

8.3.1 Agricultural Relief is given only on the agricultural value of agricultural property. In respect of farm cottages, the excess of their value over their agricultural value is removed from charge by s. 169 which provides that:-

> "(1) In determining the value of agricultural property which includes cottages occupied by persons employed solely for agricultural purposes in connection with the property, no account shall be taken of any value attributable to the fact that the cottages are suitable for the residential purposes of persons not so employed."

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SECTION IX

INSURANCE POLICIES

INTRODUCTION

9.1.1 Insurance policies are an invaluable tool in IHT planning. For that very reason, a certain amount of anti-avoidance legislation has grown up to restrict their advantages including the valuation provisions of s.167.

TWO COMMON FORMS OF POLICY

9.2.1 In most common forms of life insurance policies, a person entering into a policy pays a premium or premia in return for the right to be paid benefits on maturity and, often, on surrender. The maturity of the policy will be dependent to some extent upon the continuance or cessation of a life or lives assured. By way of illustration of the valuation principles a conventional single premium investment bond and a single, whole of life, regular premium policy providing a level sum assured will be considered.

Single Premium Investment Bonds

9.2.2 Investment bonds mimic the economic features of collective investments whilst, because they are policies of life insurance, receiving the tax treatment which applies to such policies.

9.2.3 A typical investment bond will be written on one or more lives including the life of the person to whom the policy is issued and will provide for the payment of a surrender value

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on the surrender of the policy in whole or in part at any time and a maturity value on the death of the, or of the last of, the lives assured. The surrender value, at any time, will be determined by the value of a group of assets of the insurance company accounted for in 'units' into which the premium is notionally 'invested'. It would be normal for the bond to provide for an initial premium to be paid and, at the option of the policy holder, for further premia to be paid. Often, the insurance company will apply the premium received first to a 'charge' and make a notional investment of only the net amount in units. Further annual 'charges' are then 'met' by 'encashing' small numbers of 'units'. It is important to understand that the whole mechanism of 'units', 'charges' and 'encashments' is simply a way of calculating the benefits payable under the policy. It is merely a hypothetical or fantasy world.[33] The assets notionally divided into 'units' remain at all times the property of the insurance company and the contract between the insurance company and the policy holder is simply a contract for the payment of benefits calculated in accordance with the unit mechanism in return for the policyholder's payment of premia.

Single, Whole of Life, Regular Premium Policy

9.2.4 Under a single, whole of life, regular premium policy for a level sum assured the policyholder pays premia at regular intervals of a year or less of a level amount in return for the company's undertaking to pay a fixed sum on the death of the life assured. Such policies are commonly used to create funds outside a taxpayer's estate which will not themselves bear IHT on the taxpayer's death and will be available to his heirs to meet the IHT arising on his death.

[33] It is for this reason that inverted commas have been placed on words referring to this notional investment

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THE RELEVANT STATUTORY PROVISIONS

Section 167

9.3.1 In respect of certain life insurance and annuity policies this general rule is supplemented by the specific provisions of s.167:-

> "(1) In determining in connection with a transfer of value the value of a policy of insurance on a person's life or of a contract for an annuity payable on a persons death, that value shall be taken to be not less than -
>
> (a) the total of the premiums or other consideration which, at any time before the transfer of value, has been paid under the policy or contract or any policy or contract for which it was directly or indirectly substituted, less
>
> (b) any sum which, at any time before the transfer of value, has been paid under, or in consideration for the surrender of any right conferred by, the policy or contract or a policy or contract for which it was directly or indirectly substituted.
>
> (2) Subsection (1) above shall not apply in the case of -
>
> (a) the transfer of value which a person makes on his death, or
>
> (b) any other transfer of value which does not result in the policy or contract ceasing to be part of the transferor's estate …
>
> ……………………

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(5) References in subsections (1) … above to a transfer of value shall be construed as including references to an event on which there is a charge to tax under Chapter III of Part III of this Act (apart from section 79), other than an event on which tax is chargeable in respect of the policy or contract by reason only that its value (apart from this section) is reduced."[34]

APPLYING SECTIONS 160 AND 167

9.4.1 It can be seen from sub-section 2 that the special valuation rules of s.167 will only apply to a transfer of value otherwise than on death which results in the policy or contract ceasing to be part of the transferor's estate. Where they apply, they ensure that the amount of the transfer of value will not be less than the premia which have been paid under the policy and certain other payments in respect of the surrender of rights under the policy.

Investment bonds

Entering into the policy

9.4.2 When a person enters into a policy, he will make a disposition. That disposition will be a transfer of value if it results in the value of his estate immediately after the disposition being less than it would be but for the disposition.[35] If the disposition is a transfer of value it will be a chargeable transfer unless it is an exempt transfer.[36] The disposition will certainly not be a potentially exempt transfer because the value transferred will not be

[34] Sub-section 3, which excludes from these provisions certain term policies and sub-section 4 concerning certain regular premium unitised policies are omitted

[35] Section 3(1)

[36] Section 2(1)

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attributable to property which by virtue of the transfer becomes comprised in the estate of another individual nor will it increase the estate of another individual.[37] If, therefore, the policy on inception has a value which is less than the diminution in the policyholder's estate by reason of the consideration to be given by the policyholder under the policy, there will be a chargeable transfer.[38]

9.4.3 In what circumstances will all these conditions be satisfied? One might argue that many insurance policies are worth less immediately after they are issued than the initial premium paid for them. For example, as we have seen, it is common in investment bonds for initial charges to be made before the notional 'allocation' of 'units' and for the 'units' to have a 'bid/offer spread' under which the 'price' at which they are 'allocated' in satisfaction of the premium will be higher than the 'price' at which they are 'redeemed' in satisfaction of policy benefits. The result is that if one takes out an investment bond and surrenders it immediately afterwards, the surrender value of the bond is likely to be less than the amount of the premium paid under the policy. One might argue, therefore, that the market value of the policy will similarly be less than the amount for which it was acquired.

9.4.4 That, however, is surely an incorrect view of the matter. There is a large and competitive market in investment bonds. A large number of customers of the insurance companies take out such bonds on the basis that the company's charges, including the initial charges built into the structure of the policy, are worth bearing in order to have the advantages conferred by the policy. Those are the benefits of the policy structure, the financial

37 Section 3A(2)(b)
38 Subject to s.10 which is discussed below

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strength of the insurance company, the administration of the policy and the management of the investments to which the policy benefits are linked. So the mere fact that the surrender value of the policy immediately after it comes into effect is less than the premium paid in respect of it does not mean that its market value will necessarily be less than the premium paid.

9.4.5 Of course there will be situations in which the original policyholder has made a bad bargain. For example, insurance companies offer commission to financial advisers on their products. Those advisers will often forego that commission by agreement with their clients so that a larger amount of the premium is 'allocated' to 'units' but, often, only when their clients request them to do so. A naïve client who does not do so, will have made a chargeable transfer.[39] Such chargeable transfers are not likely to be very large but if, for example, a policyholder allows his financial adviser to take 2% more commission than is the market norm on an investment policy with an initial premium of £2m, he might, subject to s.10, make a transfer of value of £40,000 (£2m @ 2%).

9.4.6 Possibly more significant, are situations where, for tax planning purposes, terms are added to otherwise standard policies which are of advantage to the issuing company with no corresponding adjustment to the premia payable on the policy. For example, after the trust 'reforms'[40] of 2006, it has been necessary to find new ways of making gifts to benefit young adults without giving absolute control of substantial assets to them. A solution offered by one insurance company is to create a policy (a "No Surrender Value

[39] Unless s.10 (see below) has the effect that the making of the policy is not a transfer of value

[40] In referring to the last Government's claim to have 'reformed' the Inheritance Taxation of trusts in 2006 we enter an altogether darker world of fantasy than the virtual world of unitised insurance policies

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Policy") which cannot be surrendered during the life of the life assured. The policy is simply the company's standard investment bond shorn of its surrender rights. The company does not offer enhanced terms to reflect the fact that the funds are not subject to immediate withdrawal. One might argue, therefore, that it is clear that those who take out such policies are paying more than the general market price for them.

9.4.7 If that is the case, does s.10 protect against an inheritance tax charge? Section 10 provides:-

> "(1) A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either -
>
> (a) that it was made in a transaction at arm's length between persons not connected with each other, or
>
> (b) that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other.
>
> ……………………………………
>
> (3) In this section -
>
> "disposition" includes anything treated as a disposition by virtue of section 3(3) above;
>
> "transaction" includes a series of transactions and any associated operations."

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9.4.8 Where an insurance policy is taken out in order to be the subject of a gift, as is commonly the case in IHT planning, it is clear that the provisions of s.10 cannot be satisfied. That is because s.10 does not look only at the disposition but also at the transaction or series of transactions of which it is a part. Where a policy is taken out with the intention of it being subject to a subsequent gift which is in fact made, it is clear that it is part of a series of transactions and that that series of transactions was intended to confer a gratuitous benefit on a person. So s.10 will not prevent either the client who makes a bad bargain in taking out an insurance policy or who takes out a No Surrender Value Policy from making a transfer of value if that policy is taken out with the intention that it will be the subject of a subsequent gift.

9.4.9 There is a further argument in relation to the No Surrender Value Policy which might protect from an IHT charge. One presumes that the company sells a reasonable number of such policies to a variety of persons who are willing to accept worse terms than those which apply to most policyholders[41] because of the tax advantages which the arrangement offers. Even so, one might expect individuals taking out such policies to negotiate with the insurance company to force an improvement in the other terms of the policy. Applying the classical economic assumption of a perfect market one would expect the insurance company to be willing to offer such enhanced terms. If it is not, it is surely because the group of potential policyholders to whom the product is relevant is too small for it to be worthwhile for the insurance company to offer special terms. In effect there is a market of those who wish to use No Surrender Value Policies for IHT planning which is separate from the general market for investment bonds. So it may be, after all, that the

[41] In the sense that the surrender rights are excluded with no corresponding reduction in the premium or increase in other benefits

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premia paid by those who take out No Surrender Value Policies are indeed set at market prices.

9.4.10 Be that as it may, where an individual takes out a policy, there *is* an immediate chargeable transfer and he subsequently makes a gift of that policy, there will be an element of double counting because of the application of s.167 to the subsequent gift. The following example illustrates the point.

Example 9.1

Mr Riddling takes out an investment bond on his own life paying a premium of £1m. The market value of the bond and its surrender value immediately upon issue is £950,000. A few days later, he makes a gift of the bond on bare trusts for his children when the market and surrender values are unchanged. A year later he dies unexpectedly early. A death benefit of £950,000 is paid under the policy.

On taking out of the bond he makes a chargeable transfer of £50,000 (£1m - £950,000). On making a gift of the bond he makes a potentially exempt transfer which proves to be chargeable by virtue of his death. Because that is a lifetime transfer which has resulted in the policy ceasing to be part of Mr Riddling's estate, s.167 applies in determining the value of the policy. The effect of s.167(1) is that the policy is not to be valued at less than the previous premium paid of £1m. So Mr Riddling had made aggregate chargeable transfers of £1,050,000, in spite of the fact that the policy has not, at any time, been worth, or had, a surrender value above, £950,000.

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The problem would be avoided if immediately upon issue the policy were held beneficially for the intended donee. If the policy is governed by UK law, that would only be possible if on issue the policyholder has an insurable interest in the life of the life assured under the policy.[42] Under the laws of many other jurisdictions, however, a policy is not void for lack of an insurable interest so there is much greater freedom for the policy to be held beneficially on issue by a person other than the life assured.

Regular premium, whole of life policies

9.4.11 Section 167 can also have a peculiar effect in respect of regular premium whole of life policies. In such policies the insurance company will always set the premia at a level where, in the early years, the premium charged in each year will be greater than that which would be charged, in a perfect market, for a single year's cover and this will reverse in later years. If one looks at each individual year, the premium one pays in an early year could be regarded economically as being paid partly for life cover in that year and partly for life cover in future years. In the early years the policy will have some market value but its market value will be less than the total of the premia previously paid under the policy. So on a transfer of the policy, s.167 is likely to impose a higher value on that transfer than the market value of the policy transferred. Section 167(3) provides an exception to the valuation rule of the section for certain policies but that sub-section applies only to term policies.

9.4.12 The following example illustrates the point:-

[42] Life Assurance Act 1774 s.1

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Example 9.2

Mr Chapeau-Brun is forty years old and takes out a whole of life policy on his own life for a level sum assured of £1,000,000. The annual premium is £8,200. When he is fifty years old he gives the policy to his son who will of course have to continue to pay the premia to maintain the policy. If the father were to take out a similar whole of life policy at the time of the gift the annual premium would be £13,000. The policy has a market value at this time of £60,000 reflecting the fact that a person buying it would receive £1,000,000 on Mr Chapeau-Brun's death and would only have to pay £8,200 per year until that time in order to do so.

The total premia paid under the policy to date have amounted to £82,000 (£8,200 x 10) so that the amount of Mr Chapeau-Brun's potentially exempt transfer is that amount, although the asset he has transferred has a market value of just £60,000.

9.4.13 It is clear that even in relation to quite straightforward life insurance policies, s.167 can have really quite surprising results. The valuation of insurance policies for IHT purposes is less straightforward than at first appears.

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