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CALCULATING THE DISCOUNT ON DISCOUNTED GIFT SCHEMES

HMRC Inheritance Tax issues a technical note

On 2 May HMRC issued a technical note on Discounted Gift Schemes (DGSs). This covers three areas:

(i) The age at which a discount cannot be given

It is HMRC's view that a discount cannot be given for somebody aged 90 or more on a true or mortality rated basis. This is on the basis that, in general, life assurance cover is not available for people who are older than this and it is HMRC's considered opinion that no one would buy the retained rights if they could not also buy insurance against the risk of early death. If there would, in practice, be no buyer then the settlor's retained rights could have no value. This would mean that there would be no discount.

(ii) Joint settlors

The previous HMRC practice was to calculate the present value of the joint rights to income – the discount – and, assuming the funds had been provided in equal amounts, apportion the discount equally so that the discounted gift made by husband and wife would be the same. HMRC call this the "pragmatic" approach.

From 1 June 2007, HMRC plans a different approach. The present value of the joint rights to "income" will be allocated between joint settlors according to the proportion that their individual discount contributes to the overall joint discount. They refer to this as the "open market based valuation" approach and it works on the basis that for married couples the related property provisions will apply for this purpose. The technical notes provide an example of how this will work. This calculation is subject to the transfer of value not exceeding the amount of the contribution actuarially made by each settlor.

As regards existing cases HMRC makes two statements:

(a) "We do not propose to re-open cases where the values transferred have been accepted in accordance with our previously adopted approach";

and

(b) "We intend to follow this (*new*) approach for **all** DGSs where the transfer takes place after 1 June 2007. We will also use this method where a transfer has taken place before that date and the pragmatic approach would provide an unreasonable valuation of the settlor's retained rights and substantial sums are involved".

It may be in this context that when HMRC talks about "values transferred having been accepted" it is referring to cases where the settlor has died – much depends on how closely it considers reported discounted gift scheme values when a return is made on form IHT 100 and whether they regard such notification that "values transferred have been accepted".

(iii) Underwriting

HMRC acknowledges differing practices within the industry.

The new basis of valuation means that, for a discount to apply, sufficient evidence of health is needed at outset to underwrite the settlor for whole of life assurance.

If no underwriting took place and the settlor dies within 7 years it will then be necessary to produce evidence of health that existed at the time the transfer was made and which was sufficient to underwrite the settlor for whole of life assurance at the time he set up the plan.

COMMENT

(a) HMRC's view that a discount cannot be given for somebody aged 90 or more is just that – a view by HMRC and no more. However, it would be prudent to follow this approach.

(b) It would seem that no element of spouse exemption will now arise on a discounted gift where the right to cash payments can continue to a surviving spouse. This element of spouse exemption has now effectively been factored into the chargeable discounted gift attributable to each of a couple.

(c) Life offices may wish to agree new schedules of discounted gift values with HMRC. A review of discounts may indeed be necessary in any event following HMRC's announcement that a rate of 6% pa is to be adopted in making discount calculations.

(d) *Life offices should ensure that sufficient underwriting evidence is obtained at outset to underwrite for whole of life assurance. What will be required will depend on the age of the settlor and his health history. It is important to underwrite on this basis*

  (i) *in order to determine the initial chargeable lifetime transfer so as not to exceed the nil rate band; and*

  (ii) *to know the appropriate chargeable lifetime transfer should the settlor die within 7 years of the gift.*

(e) *The position of existing (pre 1 June 2007) cases is uncertain if evidence of underwriting has not been obtained.*

HMRC UPDATE GUIDANCE ON THE RELIEVABILITY OF EMPLOYER PENSION CONTRIBUTIONS

Although it has not announced it, HMRC has updated its guidance in the Business Income Manual on the relievability of employer pension contributions in respect of controlling directors and dependants/close relatives of controlling directors.

BIM46035 has been updated. This continues to confirm that an employer pension contribution in respect of any director or employee will be an allowable expense unless there is a non-trade purpose for the payment. It continues to indicate that one circumstance where all or part of a pension contribution may not have been paid wholly and exclusively for the purposes of the trade is where the level of remuneration (including the pension contribution) is excessive for the value of the work undertaken by the individual for the employer.

It is indicated that one way of checking whether the contributions are paid wholly and exclusively for the purposes of the trade is to check whether the overall remuneration package for the controlling director and/or the close friend/relative of the controlling director is comparable with an unconnected employee. Where there is no comparable employee reference needs to be made to pages BIM47105 and 47106.

BIM47105 refers to specific deductions in relation to payments to dependants and close relatives of a controlling director. This repeats the comments in BIM 46035 that it is the overall remuneration package (including the pension contribution) that should be assessed and needs to be reasonable if it is to be regarded as ‘wholly and exclusively’ for the purposes of the trade.

BIM47106 indicates that “controlling directors are often the driving force behind the company. Where the controlling director is also the person whose work generates the company’s income then the level of the remuneration package is a commercial decision and it is unlikely that there will be a non-business purpose for the level of the remuneration package. It should be noted that remuneration does not include entitlement to dividends etc arising in the capacity of shareholder”.

STACK -v- DOWDEN

Unmarried couples who split up are to acquire the "divorce rights" of married couples in regard to the family home

A landmark test case brought before the House of Lords recently has led to clarification on how a jointly owned home is to be divided after an unmarried couple (or couple not in a registered civil partnership) splits up. The case, Stack -v- Dowden, was brought before the Lords after Mr Stack appealed against the Court of Appeal decision.

Mr Stack and Ms Dowden, who have four children, had lived together for 20 years. Throughout the relationship Ms Dowden, an electrical engineer, earned more than Mr Stack, a freelance builder. In October 2002 the relationship broke down and Mr Stack moved out. He then won a court order that he was entitled to half the proceeds of the house, a £770,000 home in North London. Ms Dowden appealed and obtained a ruling entitling her to at least 65% of the proceeds, as almost all of the money used as the deposit for the house, and the ongoing mortgage payments, had come from her savings.

The Law Lords agreed that Ms Dowden should keep 65% of the proceeds because she had made the greater financial contribution. Baroness Hale of Richmond, one of the Law Lords, said that the presumption of equal ownership should apply "unless the facts are very unusual". An example of this might be where one party had financed, or constructed himself, an extension or substantial improvement to the property, so that what they had now was significantly different from what they had then. However, it is the Law Lords' explanation of how they reached this decision that is more important.

Under previous law, when unmarried parties purchased a property jointly the starting point for its division was the amounts which both parties had contributed to its purchase at the outset. Therefore, if one partner paid 75% of the initial deposit and ongoing mortgage payments, the starting point for the division of the property on a split would be 75% / 25%. The other partner would then need to argue any other contributing factors that could help change the split; for example upkeep of the property, DIY, household chores etc.

The landmark ruling in Stack -v- Dowden, which affects up to two million cohabiting couples, means that where a couple own a house jointly the starting point for the division of ownership will be 50/50. It would then be up to either party to prove that their financial contribution to the property was unusual enough to fall outside of a 50/50 split, as was decided in the current case because of Ms Dowden's initial and ongoing levels of contribution to the cost of the house. This has led solicitors to urge unmarried couples to enter into a legal agreement from the outset if they are to guard against a later deemed 50/50 split if they separate.

COMMENT

For any unmarried couple now intending to buy a home together, there will be an initial presumption of equality. If either party does not wish the property to be treated as owned in 50/50 shares they should now state clearly, either on the Land Registry transfer form or in a separate deed, the shares in which they own the new home. The cost of these documents is insignificant compared with the possible ongoing court costs at a later date if there is a dispute.

SMITH AND OTHERS -v- HM REVENUE AND CUSTOMS

Back-to-back arrangements
Associated operations
Statement of Practice E4
What constitutes "full medical evidence"?

The background

This case, considered by the Special Commissioners, revolved around three identical back-to-back arrangements established by Sir John and Lady Shirley Smith.

Under each arrangement a 10 year with profits endowment was effected jointly by Sir John and Lady Shirley on their joint lives on a last survivor basis. The first annual premium to this policy was paid out of the lump sum being invested. The balance of the lump sum purchased a 9 year temporary annuity, on the joint lives of Sir John and Lady Shirley on a last survivor basis, payable annually in arrears. The net of tax annual annuity was to fund the remaining 9 premiums under the endowment. The endowment was written under trust for the benefit of a child of Sir John and Lady Shirley provided that child died leaving the settlors or a settlor surviving; otherwise at maturity date the proceeds would be held for the settlor or settlors absolutely.

The purpose of the arrangement was to secure a good rate of return under a temporary annuity contributed to substantially because of the non-taxable capital element. The annuity payments then funded a with profits endowment to provide a lump sum at the end of 10 years, which would be tax free provided the policy had remained a qualifying policy. It was not expected that any adverse inheritance tax implications would ensue.

The inheritance tax effects:

a) 50% of each premium would be regarded as a gift (transfer of value) from each of Sir John and Lady Shirley. However, the annual exemption and/or normal expenditure out of income exemption could take the premiums out of the charge to IHT.

b) The benefit at maturity would pass free of inheritance tax to the surviving settlor(s) under the reverter to settlor rule.

c) If the child and both settlors died before maturity the proceeds would pass free of IHT to the child's estate.

These IHT results will only follow if the associated operations rule (see below) is not infringed. This rule and the effect of its operation is now considered.

Associated operations

The associated operations rule, found in section 268 Inheritance Tax Act 1984 (IHTA), is a piece of anti-avoidance legislation. Without the associated operations provisions it would be possible to split some IHT transfers into separate parts with the sum of the parts being less than the value of the whole transferred. The associated operations rule counters this mischief by treating all of the separate transactions as one transfer.

Where an arrangement involves an annuity purchased in conjunction with a life policy, and so falls within section 263 IHTA, there will be an associated operation **unless** it can be proved otherwise (see below). If the settlor does not produce sufficient proof, so that the associated operations rule does apply, then under section 263 IHTA there will be a transfer of value for IHT purposes when the trust is established equal to the lesser of:

- the total of the purchase price of the annuity and the first premium paid under the life policy; and

- the value of the greatest benefit capable of being conferred at any time by the life policy, calculated as if that time were the date of the transfer.

So how can a settlor demonstrate that this rule does not apply? Well, the Inland Revenue (as it then was) issued a Statement of Practice in 1975 (SP2/75, now SPE4) in which they stated that they will not regard the purchase of the annuity and the effecting of the policy as associated operations if the policy was issued on full medical evidence of the assured's state of health **and** it would have been issued on the same terms even if the annuity had not been purchased.

The Inland Revenue have also stated that for the purposes of satisfying the first condition, at least a Private Medical Attendant's Report (PMAR) should be obtained.

It should be noted that the onus is on the investor to show that the associated operations provisions do not apply. This onus is normally discharged by producing a letter from the life office, which issued the policy, confirming that the policy was issued pursuant to obtaining full medical evidence of the assured's state of health and that it would have been issued on the same terms even if the annuity was not purchased.

Various notices issued by the ABI to its members (based on correspondence with the Inland Revenue) confirmed that to be within the Statement of Practice it was necessary for the company issuing the policy to have, as a minimum, obtained a PMAR and used it as the basis of its usual underwriting procedures as it would have done if the annuity had not been purchased.

The key issue to be determined

Lady Shirley and then Sir John both died within 7 years of establishing the trust. The case was brought in respect of Sir John's estate but on both deaths HMRC contended that the arrangement constituted associated operations but went no further with Lady Shirley.

The Special Commissioner found that, based on the facts, Sir John's arrangement **was** an associated operation as defined in section 268 IHTA so that section 263 IHTA applied. In order to reach this conclusion it was necessary to establish that the purchase of the annuities and the making of the life assurance contracts were made "with reference to one another, with a view to enabling the other to be effected" or "with a view to facilitating the other being effected". With extensive reference to the Rysaffe judgement, the Commissioner held that the policies were made "with reference to one another". Counsel for the appellants then sought to argue that the Statement of Practice applied and so there could be no associated operation.

In 2003, when Sir John died, the life office had confirmed that the life policy would have been issued on the same terms if the annuity had not been bought. But it still remained to be shown that the life policy was issued "on full medical evidence of the assured's health".

A preliminary point was considered as to whether a Statement of Practice could bind a Special Commissioner. The Special Commissioner held it could not but as HMRC felt that it would be bound by the Statement of Practice "irrespective of the strict legal position" the Special Commissioner did consider the Statement of Practice.

As far as medical evidence was concerned at outset, Sir John was medically examined by his own GP and HMRC accepted that this amounted to "full medical evidence". On the other hand, on the basis of Lady Shirley's answers in the proposal form the life office was happy to accept her at normal rates without further medical evidence.

HMRC argued that, as far as Lady Shirley was concerned, the policies were issued without full medical evidence. Even though it was only Sir John's estate that was the subject of the determination, it was still necessary to consider whether "full medical evidence of the assured's health" had been secured in connection with Lady Shirley as well as Sir John because the policies were joint lives policies.

Arguments raised for the appellants were as follows:

1. The reference to "assured" in the Statement of Practice meant the taxpayer who is sought to be made liable (i.e. Sir John). The Special Commissioner dismissed this argument on the basis that a person liable to pay inheritance tax may well insure somebody else's life, in which case he would not be the life assured. In addition, he said that when there are joint lives assured there must be full medical evidence obtained in respect of both lives assured.

2. The Inland Revenue had previously considered section 263 in connection with Lady Shirley's estate but went no further on the basis that the spouse exemption applied. The Special Commissioner thought this was not relevant to the case which was considering an appeal only in connection with Sir John's estate.

3. It was argued that Lady Shirley's answers on the proposal form did constitute "full medical evidence" which was refuted by HMRC on the basis that "full medical evidence" required, as a minimum, a PMAR. This was on the basis of an agreement between the ABI and Inland Revenue, which was common knowledge within the life assurance industry based on a number of notices issued by the ABI. But, because such notices are not available to the public and not referred to in the HMRC Inheritance Tax Manual, the Special Commissioner considered HMRC could not rely on those notices to aid the interpretation of the Statement of Practice.

4. Finally, it was argued that the Statement of Practice should be interpreted "in the light of general insurance law" with the inference that the answers by Lady Shirley to the medical questions constituted full medical evidence as they "accorded with the practice of a reasonable and prudent insurer." The Special Commissioner agreed with counsel for

HMRC that the general questions were necessary to determine whether fuller evidence was required.

The appeal by the taxpayer's estate was dismissed.

COMMENT

This outcome was confined very narrowly to a Statement of Practice, which is only applicable to back-to-back arrangements, in the area of anti-avoidance legislation. It is helpful to know though that if there are two lives assured, to be within the Statement of Practice it is essential to secure "full medical evidence" of the health of both of the lives assured and that the terms of the life policies were the same as they would have been if the annuities had not been bought.

Therefore, two conditions must be satisfied for the Statement of Practice to apply. The second ("same terms") was satisfied. But what is meant by "full medical evidence"? Clearly a medical examination is sufficient. Sir John had one. But, where there are two lives assured, it is not enough to only look at the medical evidence obtained on the individual whose estate is in question. Each of the lives needs to be considered.

It was also decided that the questions and answers in the proposal form were not "of themselves" sufficient to constitute "full medical evidence". It was made clear that the "minimum PMAR" requirement could not be relied on. Ultimately, the Commissioner decided that the following meanings were to be adopted:

"full"	=	*complete*
"medical"	=	*of or pertaining to the science or practice of medicine*
"evidence"	=	*facts and testimony in support of a conclusion*

It was decided that the answers to the questions in the proposal did not provide a complete picture of the assured's state of health. The proposal process was a mere filter. The decision begs the question that if the answers on the proposal act as a mere filter and do not provide full medical evidence what would be full medical evidence? Especially as to do other than accept the case (in Lady Shirley's case) based on the proposal received would be outside of the life office's normal practice.

The safest conclusion would be that an examination would be necessary as that would represent the "fullest" medical evidence. In practice, though, it may be that a PMAR would be enough. It seems that this is the line taken by both the ABI and Inland Revenue as evidenced by their correspondence. Even though the Commissioner did not permit HMRC to rely on these exchanges, if a minimum PMAR had been secured on Lady Shirley it is unlikely that the notice of determination would have been issued by HMRC.

It was also interesting to be reminded that Special Commissioners are not bound by any Statement of Practice. The Special Commissioner stated in his judgment that "Although a formally published Statement (such as Statement of Practice E4) might bind the Revenue, it does so because it gives rise to a legitimate expectation enforceable by judicial review. Such a Statement does not create "law" which would bind this tribunal". The Commissioner did decide this one in the light of the Statement of Practice though as HMRC specifically stated that it considered itself bound by the Statement of Practice for the purposes of the appeal.