

Excepted assets

(Lecture P1204 – 23.36 minutes)

It was never intended that business relief should be given for that part of any value transferred attributable to 'excepted assets' under S112(2) IHTA 1984 as assets which:

- have not been used wholly or mainly for the purposes of the company's business throughout the last two years (or their period of ownership, if less); and
- are not required for future use in the business.

The rationale is to prevent an individual from artificially increasing the amount of his relief entitlement by 'parking' private assets (such as a residence) in his company.

Typical examples of excepted assets are Stock Exchange investments, rental properties and substantial cash balances. However, it now appears that the provision may be less problematic than was once thought. Consider, for example, a manufacturing company which also carries on some property letting activities. Provided that the company satisfies the 'wholly or mainly trading' test set out in S105(3) IHTA 1984, business relief will be available.

In the past, it was understood that this relief would then be restricted to the extent that the value of the property letting assets impacted on the value of the shares, but HMRC Inheritance Tax accept that the word 'business' in S112(2) IHTA 1984 can cover both trading and investment businesses and so, as long as the company's assets are used in one or other of its business activities, none of them will be treated as excepted assets. Business relief should be given without restriction.

The rule excluding excepted assets from business relief is relaxed in the case of property where:

- part of the land and buildings is used exclusively for business purposes; but
- the whole of the land and buildings would otherwise have to be treated as an excepted asset because it was not used wholly or mainly for business purposes.

In these circumstances the part used exclusively for business and the rest of the property are treated as separate assets, with the value of the land and buildings as a whole being apportioned between the two parts (S112(4) IHTA 1984).

Illustration 1

Andrew is a dentist who runs a successful practice from his home in London SW3. The large house is mainly a residence for Andrew and his family, but three rooms on the ground floor are reserved as Andrew's surgery, his office and a waiting room for his patients.

Given that these three rooms are used exclusively for business purposes, they are regarded as a separate asset in the context of the IHT value of Andrew's practice, even though the house as a whole would not be treated as being used wholly or mainly for the purposes of Andrew's dental business.

Barclays Bank Trust Co Ltd v CIR (1998) is an important case on the meaning of 'excepted assets'. At the date of the shareholder's death, the deceased's company had cash balances of around £450,000. HMRC Inheritance Tax accepted that £150,000 of this amount was needed for future business use, but they argued that the remaining £300,000 was surplus to the company's requirements. The Special Commissioner agreed with HMRC Inheritance Tax. An asset consisting of money was not required for future business use merely because it might be needed should the appropriate opportunity arise in, say, two, three or seven years' time. There had to be evidence at the date of death that the money would be used for some given project or some palpable business purpose. Therefore, the cash balance of £300,000 constituted an excepted asset.

HMRC's success in the Barclays Bank case could well be described as a pyrrhic victory in the sense that the decision provided tax advisers with invaluable information about how to sidestep an excepted assets charge in the future. Many companies with large cash balances were henceforth encouraged to have regular board meetings where one of the items on the agenda was a discussion of the uses to which they might put their surplus funds. This meant that, in later years, it became harder for HMRC Inheritance Tax to advance the same arguments that had won them the day in 1998.

Another aspect that is often worth exploring, given the use of the word 'business' in S112 IHTA 1984, is this. Could it nowadays be argued, where a trading business holds substantial cash balances that are actively managed on a regular basis, that this constitutes an ancillary investment activity which cannot be caught by the excepted assets legislation?

There is no guidance in the IHT legislation (or in the Inheritance Tax Manual) as to precisely how the apportionment between any excepted assets and the remaining value of the business should be calculated. The method set out in Illustration 2 below is suggested as a just and reasonable approach.

Illustration 2 - Hector Enterprises Ltd

The balance sheet of Hector Enterprises Ltd, an unquoted trading company, shows net assets of £1,600,000 (at current market value). This includes a significant sum for goodwill and a holding of quoted shares worth £285,000. Hector has transferred his 65% holding in the company, worth £936,000, to a discretionary trust for the benefit of his daughters (other 35% is held by Hector's sister). The value transferred by Hector is:

	£
Value of shareholding	936,000
Less: Value attributable to excepted asset	
(285,000/1,600,000 x 936,000)	<u>166,725</u>
	769,275
Less: Business relief (100%)	<u>769,275</u>
	-
Add; Value attributable to excepted asset	<u>166,725</u>
	<u>166,725</u>

Contributed by Robert Jamieson