

INHERITANCE TAX - business property relief - Lloyd's underwriter - net value of business - money owing on accounts open at the date of death - whether "liabilities incurred for the purposes of the business" - appeal allowed - IHTA 1984 s110(b)

THE SPECIAL COMMISSIONERS

MICHAEL WILLIAM HARDCASTLE AND

RUTH MARGARET HARDCASTLE

(EXECUTORS OF JACK RONALD VERNEDE DECEASED)

Appellants

- and -

THE COMMISSIONERS OF INLAND REVENUE

Respondents

SPECIAL COMMISSIONER: DR A N BRICE

Sitting in London on 27 July 2000

Mr Jonathan Peacock of Counsel, instructed by Messrs Whitehead Monckton Solicitors, for the Appellants

Mr Peter Twiddy, Assistant Director, Capital Taxes Office, for the Respondents

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DECISION

The appeal

1. Mr Michael William Hardcastle and Mrs Ruth Margaret Hardcastle, as Executors of Mr Jack Ronald Vernede deceased (Mr Vernede), appeal against a Notice of Determination dated 20 December 1999 in the following form:

"The Commissioners of Inland Revenue have determined:

In relation to

a) the deemed disposal for the purposes of inheritance tax on the death on 30 March 1994 of Jack Ronald Vernede ("the Deceased"),

b) his underwriting business as a Name at Lloyd's ("the Business"),

That in computing the value of the Deceased's estate, having regard to the terms of section 5 of the Inheritance Tax Act 1984, and in ascertaining the value of any relevant business property, for the purposes of section 104 of that Act, the past

or future profits or losses of the Business shall not per se be added to or subtracted from these values."

The legislation

2. Chapter 1 of Part V (sections 103 to 114) of the Inheritance Tax Act 1984 (the 1984 Act) contains provisions which give relief for business property. Section 104 gives the relief by providing that, where the whole or part of the value transferred by a transfer of value is attributable to the value of any relevant business property, the whole or that part of the value transferred shall be treated as reduced by 100% in the case of property falling within section 105(1)(a). Section 105 defines relevant business property and the relevant parts of the section provide:

"105 Relevant business property

(1) Subject to the following provisions of this section ... in this Chapter "relevant business property" means, in relation to any transfer of value,-

(a) property consisting of a business or interest in a business ..."

3. Section 110 contains provisions about the valuation of a business and the relevant parts provide:

"110 Value of business

For the purposes of this Chapter-

(a) the value of a business or of an interest in a business shall be taken to be its net value;

(b) the net value of a business is the value of the assets used in the business (including goodwill) reduced by the aggregate amount of any liabilities incurred for the purposes of the business;

(c) in ascertaining the net value of an interest in a business, no regard shall be had to assets or liabilities other than those by reference to which the net value of the entire business would fall to be ascertained."

The evidence

7. An agreed bundle of documents was produced. This included a statement of agreed facts.

The facts

8. From the evidence before me I find the following facts.

9. At the date of his death on 30 March 1994 Mr Vernede was an underwriting member of Lloyd's of London and was a member of eleven syndicates. He had an estate protection plan policy in respect of his underwriting activities under which there was an excess of £251,900.00. The policy provided that the re-insurers would, if the policyholder died during the policy period, indemnify his estate

against all losses arising on any account for which an underwriting result was not formally notified to the policy holder before the date of his death.

10. On 22 July 1994 the Appellants signed the Inland Revenue Account for Inheritance Tax (the Account). This stated that the net value of Mr Vernede's interest in his business was £265,507.61. (That was the amount of the funds he held at Lloyd's.) The Account also indicated that there were underwriting losses of £301,311.28 for years prior to the date of Mr Vernede's death. (These consisted mainly of the excess under the estate protection plan of £251,900.00 and also some deferred losses which had been announced prior to Mr Vernede's death but which had not been called for payment.) The Account claimed business property relief for the amount of £265,507.61 and sought to treat the losses of £301,311.28 as a deduction from the rest of the estate.

11. Mr Vernede's Will was proved by the Appellants on 2 August 1994. The Grant of Probate certified that the net value of his estate in the United Kingdom amounted to £623,806.00.

The issue

12. It was agreed that Mr Vernede's underwriting activities constituted a business within the meaning of section 105(1)(a) and that business property relief was available. It was also agreed that Mr Vernede's funds at Lloyd's, amounting to £265,507.61, were "assets used in the business" within the meaning of section 110(b). It was further agreed that the dispute concerned only the amounts owed by Mr Vernede on accounts for which a result had not been notified before the date of death. I take that to mean the sum of £251,900.00 being the excess under the estate protection plan policy.

13. The Appellants argued that, when computing the net value of Mr Vernede's business for the purposes of business property relief, the money owing on the open accounts was not "a liability incurred for the purposes of the business" within the meaning of section 110(b) and so should not be deducted from the value of the assets used in the business but from the value of Mr Vernede's other estate. The Inland Revenue argued that the money owing on the open accounts was "a liability incurred for the purposes of the business" and so should be deducted from the value of the assets used in the business.

14. Thus, the issue for determination in the appeal was whether, in ascertaining the net value of the business, the money owing on the open accounts was "a liability incurred for the purposes of the business" within the meaning of section 110(b).

15. I was asked to give a decision in principle leaving the amount of the figures to be determined at a later date.

The arguments of the Appellants

16. For the Appellants Mr Peacock first argued that trading profits were not assets of a business and trading losses were not liabilities. Profits and losses were very different conceptually from assets and liabilities and he cited *Reed v Young* [1986] STC 285 at 289. In the context of a Lloyd's name, the assets used in the business were the funds deposited at Lloyd's (*Owen v Sassoon* (1951) 32 TC 101) and liabilities incurred for the purposes of the business would include any sums borrowed to fund the deposits at Lloyd's. The money owed by Mr Vernede on the

open accounts constituted trading losses and not liabilities incurred for the purposes of the business.

17. Next, Mr Peacock argued that a trading contract was property for the purposes of section 5(1) of the 1994 Act and, like all other property belonging to a deceased person, had to be valued for the purposes of inheritance tax as part of his estate. Such a trading contract could have either a positive or negative value but it did not constitute either a profit or a loss. If it had a positive value it was not "an asset used in the business" because it was the very business itself. For the same reason, if it had a negative value it was not a "liability incurred for the purposes of the business". In any event, inheritance tax was a tax on capital and not on revenue and the trading contracts were revenue items. Although Mr Vernede's contract with Lloyd's might be a capital asset, following *Van Den Berghs Limited v Clark* (1935) 19 TC 390 the trading contracts were made in the course of the underwriting business as in *Anglo Persian Oil Company Limited v Dale* (1931) 16 TC 253. Mr Vernede was a member of eleven syndicates and would have entered into a number of contracts,

18. Thirdly, Mr Peacock argued that section 110(a) provided that the value of a business "shall be taken to be" its net value and that was in substance a deeming provision and a departure from the true value of the business. "Net value" was defined in section 110(b) and was not the sort of valuation as would be undertaken by an accountant but was an artificial construct. Section 110(b) did not refer to "the assets and liabilities of the business" and he cited *Fetherstonhaugh v IRC* (formerly *Finch and Others v IRC*) [1984] STC 261 at 267g-268b.

19. Finally, Mr Peacock argued that the words of section 110(b) were clear and unambiguous and should be construed by looking merely at what was said and he relied upon *Cape Brandy Syndicate v IRC* (1921) 12 TC 358 at 366 and *Inland Revenue Commissioners v Quigley* [1995] STC 931 at 938-939. No implication should be made unless it was necessary and the statute unambiguously so required and he cited *Carr v Armpledge* [2000] STC 410 at 416. However, even when considered within the wider context of the 1984 Act, the same conclusion would be reached. That wider context indicated that a restrictive interpretation of the phrase "assets used in the business" was intended. Trading contracts which were open at the date of death and which had a positive value would not be "assets used in the business" and the same principle applied to those with a negative value.

The arguments of the Respondents

20 For the Respondents Mr Twiddy accepted that assets and liabilities were distinct from profits and losses. Section 5 of the 1994 Act imposed a tax on capital reduced by liabilities and not a tax on profits reduced by losses. For the purposes of business property relief profits and losses had to be ignored unless they gave rise to an asset or liability.

21. However, Mr Twiddy argued that a contract in the course of trading was a chose in action which was an asset as it was a means whereby the business was carried on. Trading contracts were not the business but were needed to carry on the business and so they were assets used in the business. In the context of underwriting they produced the premium income. If they were profitable they would increase the net value of the business for the purposes of business property relief. Conversely, liabilities were debts presently payable or payable at a future date. A trading contract with a negative value was a liability incurred in

the course of carrying on the business and so was incurred for the purposes of the business.

22. Thirdly, Mr Twiddy argued that it was necessary to draw a notional balance sheet and to identify the assets and the liabilities and then to exclude assets not used in the business. For very many years underwriting businesses had been valued by reference to funds deposited and also contracts entered into which were treated as choses in action. However, the valuations of such contracts were complex and required actuarial advice. Accordingly, in practice the deposits were valued but the contracts were left to run for three years and when the profits or losses were known a valuation was made. That was a practical approach. He referred to the judgement of Vinelott J at first instance in *Finch And Others v Inland Revenue Commissioners* [1983] 1 WLR 405 at 409C-F; that had decided that settled land occupied by a tenant for life and used by him in his farming business was not an asset of that business. That was the context of the decision.

Reasons for decision

23. In considering the arguments of the parties I start with the legislation. Section 4 of the 1994 Act provides:

"4 Transfers on death

(1) 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."

24. Section 5 of the 1994 Act provides:

"5 Meaning of estate

(1) For the purposes of this Act a person's estate is the aggregate of all the property to which he is beneficially entitled. ...

(3) In determining the value of a person's estate at any time his liabilities at that time shall be taken into account."

25. Thus section 4 provides that, on a death, a valuation must be made of the whole estate as if a transfer had taken place immediately before the death. Section 5 provides that an estate is the aggregate of all the property to which the deceased was beneficially entitled less "his liabilities at that time". Neither section 4 nor section 5 is confined to property which is capital in nature. Section 5(1) refers to all property which, therefore, includes income accruing to the date of death. Within the context of section 5 the word "liabilities" must include all debts, both of a capital and income nature, accruing at the date of death.

26. Pausing there it is possible to determine how the business of an underwriter should be valued for the purposes of inheritance tax. It is necessary to prepare a notional account as at the time which is immediately before the death. Not only the assets and liabilities of the business would be brought into account but also any trading profits or trading losses. The assets would be property of the deceased within the meaning of section 5(1) and the liabilities would be liabilities of the deceased within the meaning of section 5(3). Trading profits of the deceased would similarly be property of the deceased within the meaning of

section 5(1) and conversely trading losses would be liabilities of the deceased within the meaning of section 5(3).

27. It is within that context that the provisions for business property relief must be considered. The importance of the context was emphasised by Lord Oliver in *Fetherstonhaugh* in the Court of Appeal where he said, at page 267a:

"All the assets of the estate, to the value of which the tax is attributable, are assets "of" the decedent, and in order to identify which of the decedent's assets can be taken into account in assessing the value of the business, the legislature adopts the only practicable test - were they assets which were "used in the business"? - it being... necessarily postulated that the assets are assets, the value of which forms part of the value transferred, and therefore which belong to the decedent. Thus the "assets" and "liabilities" referred to in the sub-paragraph are not at this stage identified as assets or liabilities "of" the business. They are simply assets, the value of which is included in the transfer of value, and are to be identified as business assets for the purposes of the ascertainment of the net value by reference to whether they were used by the deceased in his business, just as those of the deceased's liabilities which are to be allowed as a deduction are to be ascertained by asking whether they were incurred by him for the purposes of the business."

28. Thus the calculation of the net value of the business for the purposes of business property relief does not involve the same calculation as the valuation of the business for the general purposes of inheritance tax. For business property relief only two elements of the calculation may be brought into account, namely the assets used in the business and the liabilities incurred for the purposes of the business.

29. Both parties agreed that trading profits were not assets used in the business and that trading losses were not liabilities incurred for the purposes of the business. Accordingly, it is necessary to characterise the amount in dispute in this appeal. Mr Peacock argued that that amount consisted of trading losses whereas Mr Twiddy argued that it represented the value of trading contracts which were assets used in the business, albeit of negative value.

30. The only evidence before me of the nature of the amount in dispute in the appeal was that it was the sum of £251,900.00 which was the excess on the estate protection plan policy which reinsured the losses arising on accounts for which an underwriting result had not been formally notified to Mr Vernede at the date of his death. The wording of the estate protection plan policy leads to the conclusion that the sum was "losses arising on accounts" and that would lead to the conclusion that the nature of the sum is trading losses.

31. There was no evidence before me about any individual trading contracts which might have been entered into by Mr Vernede. There was no evidence about the method in which Mr Vernede conducted his underwriting business through the syndicates and their agents. There was no evidence about Mr Vernede's relationships with his agent or with Lloyd's, nor was there any evidence of the documents which Mr Vernede no doubt executed on joining Lloyd's. However, as the arguments of both parties assumed that Mr Vernede did enter into individual insurance contracts I proceed on the basis that that occurred.

32. The question therefore arises as to whether the individual trading contracts were "assets used in the business". In the absence of an direct authority on the meaning of those words in the inheritance tax legislation it is, I think, permissible

to turn for assistance to the authorities on the subject of expenditure for income tax purposes. There a distinction is made between expenditure which brings into existence an asset for the enduring benefit of the trade on the one hand and ordinary commercial contracts on the other. In Van den Berghs at page 431 Lord MacMillan distinguished between commercial contracts made in the course of the carrying on of the business and contracts relating to the whole structure of the profit-making apparatus. He said:

"The three agreements which the Appellants consented to cancel were not ordinary commercial contracts made in the course of carrying on of the trade; they were not contracts for the disposal of their products or for the engagement of agents or other employees necessary for the conduct of their business; nor were they merely agreements as to how their trading profits when earned should be distributed as between the contracting parties."

33. That decision makes it clear that some trading contracts may be "assets used in the business" but that ordinary commercial contracts made in the course of carrying on the trade are not. Applying the principles in Van Den Berghs to the facts of the present appeal I find that the insurance contracts in respect of which a result had not been notified to Mr Vernede at the date of his death were ordinary commercial contracts made by Mr Vernede in the course of carrying on his business as an underwriter. They were contracts for the disposal of his product which was the assumption of risk in return for a premium. Thus, for the purposes of business property relief, if they gave rise to a profit they should not be regarded as assets used in his business and, if they gave rise to a loss (as in the present appeal) they do not constitute liabilities incurred for the purposes of the business.

34 In one sense it could be said that every insurance contract is a liability incurred for the purposes of the business because potential liabilities are incurred with every insurance contract. However, it is clear from the context of section 110(b) that the liabilities referred to in that section are those which counterbalance the assets used in the business and so would not include ordinary liabilities incurred in the day to day running of the business, for example unpaid rent of business premises or money owing on ordinary commercial contracts.

35 The fact that underwriting profits and losses are treated as income for income tax purposes, and not as sums paid for the acquisition of assets, is consistent with my conclusion.

Decision

36. My decision on the issue for determination in the appeal is that, in ascertaining the net value of Mr Vernede's business, the money owing on open accounts was not a liability incurred for the purposes of the business within the meaning of section 110(b).

37. The appeal is, therefore, allowed.

DR A N BRICE

SPECIAL COMMISSIONER

Date of Release: 9th October 2000

SC 3035/2000