

CHAPTER 21

SECTION 39A IHTA 1984

21.1 Introduction

In this chapter, we shall look specifically at the provisions of **Section 39A** of Inheritance Tax Act of 1984. S.39A affects the way that Business and Agricultural Property Relief is allocated in the death estate. BPR or APR will be allocated in **one of two ways**.

If business or agricultural property is given by specific gift, then any BPR or APR **attaches to the specific gift**. This means that the value of the gift for IHT purposes is reduced by the appropriate amount of business or agricultural property relief. For example, if an individual dies and leaves shares in an unquoted trading company to his son by specific gift, the IHT value of that specific gift is likely to be reduced to zero by the allocation of 100% BPR.

[IHTA 1984, s.39A\(2\)](#)

However if business or agricultural property is given by residuary legacy - i.e. it is left to devolve with the residue of the estate - then S.39A is likely to apply to "spread" the APR or BPR between the residue and any specific gifts.

[IHTA 1984, s.39A\(3\)](#)

21.2 Conditions for "spreading" provisions to apply

The Will must do three things:

- (a) Firstly there must be **one or more specific gifts of non-agricultural or non-business property**. These gifts could either be chargeable or exempt. By "non-agricultural" or "non-business" property, we mean specific gifts of assets such as cash, quoted shares, or private residences etc - assets which do not qualify for APR or BPR.
- (b) Secondly, **some part of the death estate must be exempt** from inheritance tax. This means that either one or more of the specific gifts must be to a spouse or charity, or some part of the residue of the estate must be left to an exempt beneficiary.
- (c) The **residue of the estate must contain property qualifying for business or agricultural property relief**.

If these three criteria apply to the death estate, the provisions of S.39A must be considered.

21.3 Effect of spreading provisions

Where S.39A applies, any APR or BPR available on assets in the residue of the estate, is partially allocated against the value of any specific gifts. The effect of the spreading provisions is to reduce the IHT value of the specific gifts within the estate. If the specific gift in question is exempt from Inheritance Tax - i.e. assets are being left by specific gift to a spouse or charity - the

effect of the spreading provisions is to allocate APR or BPR to an already exempt legacy, thereby **wasting either the relief or the exemption**.

If this is the case, the **effect of S.39A will be to increase the overall IHT liability on the estate**. Note that S.39A only allocates APR or BPR to specific gifts of non-business or non-agricultural property. If the Will leaves a specific gift of agricultural or business property, the APR or BPR attaches to that specific gift and it is disregarded for spreading purposes.

21.4 The "spreading fraction"

To work out how much of the APR or BPR in the residue is allocated to the specific gift, we use the "**spreading fraction**" in S.39A.

S.39A(3) tells us that the value of a specific gift for IHT purposes shall be taken to be an "**appropriate fraction**" of its actual value.

$$\frac{\text{Total value of estate after BPR/APR Less} \quad \text{Specific gifts of BPR/APR property}}{\text{Total value of estate before BPR/APR Less} \quad \text{after BPR/APR}} \\ \frac{\text{Specific gifts of BPR/APR property}}{\text{before BPR/APR}}$$

At first glance this looks horribly complicated, so it is worth going through each of the four variables within the fraction.

We will start with the bottom half of the fraction. On the left hand side we have the total value of the estate before any APR or BPR has been deducted. This is simply the gross estate - ie the value of all of the assets in the estate minus any appropriate liabilities. From this we deduct any specific gifts of agricultural or business property, before the deduction of any APR or BPR. Therefore if the Will leaves agricultural or business property entirely within the residue of the estate, as there are no specific gifts of such property, this figure will be zero.

We turn now to the top half of the fraction, starting with the figure on the left hand side. This is the total value of the estate, net of any agricultural or business property relief. This is simply the figure on the bottom left of the fraction, less any APR or BPR. Finally in the top right of the fraction, you will find specific gifts of agricultural or business property, net of any appropriate APR or BPR. Once again this will often be nil, either because there are no specific gifts of agricultural or business property, or because any such specific gifts are wiped out by 100% APR or BPR.

The effect of S.39A is to allocate some BPR or APR from the residue of the estate, against the specific gift.

The IHT value of a gift is the actual value of the gift less any APR or BPR. The IHT value obtained by applying the spreading fraction, is essentially the net value of the specific gift after APR or BPR has been allocated. This is what S.39A(3) means by "**an appropriate fraction of its value**".

Illustration 1

A taxpayer died in October 2010 having made no lifetime gifts.

In his Will, the deceased made a specific legacy of £500,000 in cash to his wife. The residue of the estate was left to his son. The residue consisted of quoted shares worth £400,000 and a business worth £300,000. The business qualified for 100% BPR, therefore £300,000 of BPR is currently in the residue of the estate. (Note that there are no specific gifts of agricultural or business property.)

Whenever you see business property in the residue of an estate, you should always think about whether S.39A will apply. In this situation, there is a specific gift. This is the £500,000 cash left to the wife. We also have something in the estate that is exempt from IHT - again this is gift to the wife. Finally we have business property in the residue of the estate. As we have all three relevant variables, S.39A will apply.

In any S.39A situation, the first thing to do is to make a tabular summary of the estate.

	<i>Gross</i> £	<i>BPR/APR</i> £	<i>Net</i> £
Cash	500,000	nil	500,000
Quoted shares	400,000	nil	400,000
Business	<u>300,000</u>	<u>300,000</u>	<u>nil</u>
	<u>1,200,000</u>	<u>300,000</u>	<u>900,000</u>

The whole point of S.39A is to allocate BPR against the specific gift, which in this instance is £500,000 left to the wife. The IHT value of the specific gift is £500,000 multiplied by the spreading fraction in S.39A:

$$\text{£}500,000 \times \frac{900000 - 0}{1200000 - 0} = \text{£}375,000$$

On the bottom left we have the gross value of the estate, before any BPR or APR. From the table you will see that this is £1.2million. From this we deduct any specific gifts of agricultural or business property, before APR or BPR. As no business property was left by specific gift, this figure is zero.

On the top of the fraction we have the net value of the estate, after any APR or BPR. Again, from the table, you will see that this figure is £900,000. From this we deduct any specific gifts of agricultural or business property, after APR and BPR. Again as no business property was left by specific gift, this figure is zero. The spreading fraction is therefore 9 over 12.

Under S.39A, the Inheritance Tax value of the specific gift is reduced to £375,000. This means that £125,000 of the BPR in the residue has been spread and allocated against the gift of £500,000, thereby reducing its IHT value to £375,000. As this is a gift to a spouse, this £375,000 is exempt from IHT. The effect of S.39A in this instance, has therefore been to waste £125,000 worth of BPR.

The final step is to calculate the Inheritance Tax due.

Death estate:	£	
Estate after BPR/APR	900,000	
Less: exempt legacy (per fraction)	<u>(375,000)</u>	
	525,000	
Nil band at death	325,000	
Less: CTs in 7 years before death	<u>(nil)</u>	
Nil band available	<u>(325,000)</u>	
Taxable	<u>£200,000</u>	
 IHT @ 40%	 <u>£80,000</u>	

21.5 Planning to avoid S.39A "spreading"

As we saw in the previous illustration, the effect of S.39A can be to allocate BPR to an already exempt legacy, thereby increasing the amount of chargeable estate and increasing the Inheritance Tax due. It is therefore sensible tax planning to **draft a Will in such a way that S.39A does not have this effect**. However if a Will is drafted such that S.39A applies, all is not lost as the situation can be **rectified after death by the prudent use of a Deed of Variation**.

Remember that if business property passes by specific gift, BPR attaches to that gift and the spreading rules do not apply. Therefore in the above illustration, the Will can be varied such that the business which was previously in the residue of the estate, is instead left by specific gift to the son.

Illustration 2

From the previous illustration, the Will left a cash legacy to the spouse and the residue of the estate to the son. The residue of the estate included quoted shares and a business carrying 100% BPR. A Deed of Variation should therefore be entered into within 2 years, including a statement under S.142. In the Deed of Variation, the Will is altered such that the business now passes by specific gift to the son, rather than within the residue.

As S.142 makes the variation effective for IHT, BPR will now attach to the specific gift, and will not be partially spread against the exempt gift to the wife as it previously was under S.39A. Under this new arrangement, S.39A will not apply as there is no longer any business property in the residue of the estate. The effect of the variation will be to allocate all of the BPR to the chargeable legacy. Therefore the IHT value of the exempt legacy will be £500,000, and the chargeable estate will be lower. If the Deed of Variation is entered into after the IHT has been paid, an IHT repayment will be made to the Executors.

21.6 S.39A and single grossing

There is an interaction between S.39A and the "single grossing" provisions covered previously.

Illustration 3

A Will leaves a variety of specific and residuary legacies. The Will leaves a cash legacy of £400,000 to the son, together with shares in an unquoted trading company worth £50,000. The residue of the estate is left wholly to the wife. The residue includes a farm worth £250,000, and a private residence worth £200,000. The farm qualifies for £100,000 APR (i.e., 50% of its agricultural value).

As the unquoted shares are left to the son by specific gift, the BPR of £50,000 attaches to that gift. The IHT value of the gift of unquoted shares is therefore reduced to zero. However as there is agricultural property in the residue of the estate, we must consider whether S.39A applies.

S.39A will apply to "spread" the APR if there is a specific gift of non-business property, if something in the estate is exempt, and there is business or agricultural property in the residue. All three apply here, therefore S.39A will take effect.

What we will therefore do is allocate some of the £100,000 of APR against the cash legacy of £400,000 to the son. Note that S.39A does not necessarily allocate APR or BPR against an exempt legacy. In this instance, APR is being taken from the residue and allocated to a chargeable legacy.

The other thing to note is that where a Will leaves a tax free specific gift and a wholly exempt residue, we must calculate the IHT at the grossed up rate of 40 over 60. This is because the son will receive the cash gift "free of tax", with any tax on the gift being payable out of the residue of the estate.

Where S.39A applies in conjunction with single grossing, we **must apply the S.39A rules first**. This will give us the IHT value of the cash gift to the son. Having arrived at the IHT value of the tax free legacy, we can then move on and do a single grossing calculation. As always, whenever S.39A applies, we prepare a tabular summary of the estate.

	Gross £	BPR/APR £	Net £
Cash	400,000	nil	400,000
Unquoted trading co. shares	50,000	50,000	nil
Farm	250,000	100,000	150,000
Private residence	<u>200,000</u>	<u>nil</u>	<u>200,000</u>
	<u>900,000</u>	<u>150,000</u>	<u>750,000</u>

We have summarised the gross value of all of the assets in the estate, and deducted APR or BPR where appropriate.

The shares qualify for 100% BPR, and the farm qualifies for £100,000 of APR. The gross value of the estate is therefore £900,000 which, after APR and BPR, gives a net value of £750,000. This table helps us to calculate the IHT value of the specific gift to the son. The gift to the son, before APR, is £400,000. We multiply this by the spreading fraction in S.39A:

$$\text{£}400,000 \times \frac{750000 - 0}{900000 - 50000} = \text{£}352,941$$

The figure on the bottom left is the gross value of the estate before APR or BPR. From this we deduct the value of any specific gifts of agricultural or business property, before APR or BPR. The shares were a specific gift of business property, so this figure is £50,000. On the top left of the fraction is the net value of the estate after APR or BPR.

On the top right of the fraction, we have any specific gifts of agricultural or business property, after APR or BPR. The only specific gift of business property was the gift of shares. The shares are covered by 100% BPR, so their IHT value is zero.

The S.39A spreading fraction is 75 over 85. This means that the IHT value of the specific gift to the son is reduced to £352,941. This "reduced" IHT value simply means that some of the APR from the residue of the estate has been allocated to the specific cash gift.

Gift to son	£
Less: APR allocated by S.39A	<u>400,000</u>
Value of gift for IHT purposes	<u>(47,059)</u>
	<u>352,941</u>

The final step is to calculate the IHT. As we have a tax free specific legacy - ie the cash gift to the son - and a wholly exempt residue, we calculate the tax using single grossing. The gross value of the estate is £900,000. This is distributed via two specific gifts and a gift of residue as follows.

	Cash gift £	Shares £	Residue £	Total £
Gross	400,000	50,000	450,000	900,000
Less: APR/BPR	(47,059)	(50,000)	(52,941)	(150,000)
Net	<u>352,941</u>	<u>nil</u>	<u>397,059</u>	<u>750,000</u>

Chargeable as to son	Exempt as to spouse
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The chargeable estate is therefore £352,941. The IHT is as follows:

	£
Total chargeable estate	352,941
Less: nil band remaining	(325,000)
Taxable	<u>£27,941</u>
IHT @ $\frac{40}{60}$	<u>£18,627</u>

As this is a single grossing situation, we calculate the IHT using the grossed up rate of 40 over 60, giving IHT due of £18,627. This is payable out of the residue of the estate, and will therefore be effectively borne by the wife.

This is quite a complex example as it involves an interaction of two tricky technical rules - i.e. Section 39A and the single grossing provisions.

21.7 S.39A and double grossing

As is the case with single grossing, where S.39A applies in conjunction with double grossing, we **apply the S.39A rules first**. This will give us the IHT value of the specific gift(s). We then use this number in our double grossing calculations.

Illustration 4

Anthony Beck died in March 2011. In the 7 years prior to his death he made chargeable transfers totalling £108,000. His estate at death was as follows:

	£
Family home & possessions in Cambridge	500,000
Farmland in Suffolk	600,000
Cash & quoted shares	450,000
Total	<u>1,550,000</u>

Anthony had bought the farmland in the 1970s and it has been let out on a long lease to a dairy farmer since 1981. The land had an agricultural value of £480,000.

Anthony's will left his house and possessions to his daughter, Karen. The remainder of the estate is to be divided equally between his wife, Kate, and his son, Brian.

We will calculate the IHT payable as a result of Anthony's death and show how the estate will be distributed among the beneficiaries.

Section 39A IHTA 1984 applies because:

- a) there is a specific gift;
- b) part of the estate is exempt; and
- c) business or agricultural property forms part of the residue.

APR is available on the farmland at 50% because:

- it is tenanted land;
- the lease was signed pre 1995; and
- vacant possession cannot be obtained within 2 years of the death.

Therefore we summarise the estate as follows:

	<i>Gross</i> £	<i>BPR/APR</i> £	<i>Net</i> £
House	500,000	NIL	500,000
Farm	600,000	240,000	360,000
Cash etc	<u>450,000</u>	<u>NIL</u>	<u>450,000</u>
	<u>1,550,000</u>	<u>240,000</u>	<u>1,310,000</u>

The IHT value of the specific gift (i.e. the house to Karen) is therefore £500,000 multiplied by the spreading fraction in S.39A:

$$\text{£}500,000 \times \frac{1310000 - 0}{1550000 - 0} = \underline{\text{£}422,581}$$

We now look at the will to see whether grossing is required.

- | | |
|--|------------|
| Tax free legacy; and |) DOUBLE |
| A partly exempt / partly taxable residue |) GROSSING |

We therefore follow the 6-step double grossing procedure.

Step 1: Gross up the tax-free legacy as if it was the only part of the estate chargeable to IHT (i.e. "single grossing"):

	£
Chargeable estate (house to Karen)	422,581
Less: nil band £(325,000 - 108,000)	<u>(217,000)</u>
Taxable	<u>205,581</u>
 IHT @ 40/60	 <u>£137,054</u>
 Gross legacy £(422,581 + 137,054)	 <u>£559,635</u>

Step 2: Calculate the chargeable value of the estate and compute notional tax based on this estimated value:

	£
Total estate (after APR)	1,310,000
Less: gross legacy	<u>(559,635)</u>
Residue	<u>750,365</u>
 50% chargeable to tax	 <u>£375,182</u>
 Taxable estate: £(559,635 + 375,182)	 934,817
Less: nil band	<u>(217,000)</u>
Taxable	<u>717,817</u>
 IHT @ 40% (notional)	 <u>£287,127</u>

Step 3: Use the notional tax to work out an "estate rate":

Estate rate:

$$\frac{287,127}{934,817} \times 100 = 30.7148\%$$

Step 4: Using this estate rate, gross up the tax-free legacy as in Step 1 ("double gross"):

$$£422,581 \times \frac{100}{100 - 30.7148} = £609,915$$

This is now the gross amount (before tax) of the specific legacy to Karen.

Step 5: Calculate the chargeable value of the gross estate and compute IHT based on this value. This gives the actual IHT payable.

	£
Total estate (after APR)	1,310,000
Less: gross legacy	<u>(609,915)</u>
Residue	<u>700,085</u>
50% chargeable to tax	350,042
Add: gross legacy	<u>609,915</u>
Chargeable estate	<u>959,957</u>
Less: nil band	<u>(217,000)</u>
Taxable	<u>742,957</u>
IHT @ 40% (actual)	<u>£297,183</u>

Step 6: Recompute the estate rate and use this to show the burden of tax and how the estate is to be distributed.

Estate rate:	
<u>297,183</u> × 100	<u>30.9579%</u>
959,957	
Tax on tax-free gift to Karen:	
£609,915 × 30.9579%	188,817
Tax on chargeable residue:	
£350,042 × 30.9579%	<u>108,366</u>
Total	<u>£297,183</u>

The tax on the tax-free legacy (£188,817) will be suffered equally (£94,408 each) by the residuary legatees (Kate (wife) and Brian (son)).

The tax on the chargeable residue will be suffered by Brian.

	£
Legacy to Karen	500,000
$\frac{1}{2}$ Residue to Kate £(525,000 - 94,408)	430,592
$\frac{1}{2}$ Residue to Brian £(525,000 - 94,409 - 108,366)	322,225
IHT to HMRC	<u>297,183</u>
Total estate	<u>1,550,000</u>

Example 1

Matthew died in October 2010 leaving the following estate:

Painting to wife	£200,000
Farm to son	£180,000 (50% APR)
Residue to daughter	Cash £175,000 Unquoted shares £275,000 (100% BPR)

Lifetime transfers (after exemptions) totalled £120,000.

Calculate the IHT payable on Matthew's death.

Answer 1

As Matthew's estate contained one or more specific gifts, an exempt legacy and some business property in the residue, S.39A will apply.

	<i>Gross</i> £	<i>BPR/APR</i> £	<i>Net</i> £
Painting	200,000	0	200,000
Farm	180,000	90,000	90,000
Cash	175,000	0	175,000
Unquoted shares	<u>275,000</u>	<u>275,000</u>	<u>0</u>
	<u>830,000</u>	<u>365,000</u>	<u>465,000</u>

Value of paintings to wife:

$$\text{£}200,000 \times \frac{465000 - 90000}{830000 - 180000} = \text{£}115,385$$

This gift is exempt from IHT.

Death estate:	£	
Estate after BPR/APR		465,000
Less: exempt legacy		<u>(115,385)</u>
		349,615
Less: Nil band at death	325,000	
Less: CTs in 7 years before death	<u>(120,000)</u>	
		<u>(205,000)</u>
Taxable		<u>144,615</u>
IHT @ 40%		<u>£57,846</u>