# The Burden of Inheritance Tax on Lifetime Transfers

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Careful consideration needs to be given to how the burden of inheritance tax on lifetime transfers should be borne.

There are two situations in which a charge to inheritance tax will arise in respect of property which is transferred by an individual ("the transferor") during his lifetime.

The first situation is where a transferor makes a transfer of value during his lifetime, other than an exempt transfer ("a lifetime chargeable transfer"). The charge to tax can arise in one of two ways. The transfer of value may be chargeable when made, for example upon the creation inter vivos of an ordinary discretionary trust. In such a case, tax will be provisionally calculated at lifetime rates, but will be recalculated at death rates (tapered by 20 per cent per annum if the transferor survived the transfer by more than three years) if the transferor dies within seven years of the transfer, and a balancing payment will have to be made if the recalculation results in a higher amount of tax being payable. Alternatively, the transfer of value may be potentially exempt when made, for example upon the creation of an interest in possession trust or upon a gift to an individual. In such a case, a charge to tax will only arise if the transferor dies within seven years of the transfer, and the charge will be at death rates (subject to tapering).

The second situation is where a transferor makes a gift of property during his lifetime, but reserves a benefit from the property at any time during the period of seven years before his death. In such a case, the property in question ("property subject to a reservation") is treated as falling within his estate at his death, or if he relinquished the benefit within seven years before his death he will be treated as having made a potentially exempt transfer of the property at the date when the benefit was relinquished (which will ex hypothesi have failed).

The question of who is liable to the Revenue for inheritance tax due in these two situations is dealt with in Part VII. Section 199 (entitled "Dispositions by transfer") applies to tax due in respect of lifetime chargeable transfers. This section provides

"(1) The persons liable for the tax on the value transferred by a chargeable transfer made by a disposition ... of the transferor are:

(a) the transferor;

(b) any person the value of whose estate is increased by the transfer;

(c) so far as the value is attributable to the value of any property, any person in whom the property is vested (whether beneficially or otherwise) at any time after the transfer, or who at any time is beneficially entitled to an interest in possession in the property;

(d) where by the chargeable transfer any property becomes comprised in a settlement, any person for whose benefit any of the property or income from it is applied.

(2) Subsection (1)(a) above shall apply in relation to:

(a) the tax on the value transferred by a potentially exempt transfer; and

(b) so much of the tax on the value transferred by any other chargeable transfer made within seven years of the transferor's death as exceeds what it would have been had the transferor died more than seven years after the transfer

with the substitution for the reference to the transferor of a reference to his personal representatives..."

Section 200 is entitled "Transfer on death" and sets out the provisions relevant to (inter alia) the payment of tax attributable to property subject to a reservation. Subsection (1) provides as follows:

"The persons liable for the tax on the value transferred by a chargeable transfer made (under section 4 above) on the death of the person are:

(a) so far as the tax is attributable to the value of property which either

(i) was not immediately before the death comprised in a settlement, or

(ii) was so comprised and consists of land in the United Kingdom which devolves upon or vests in the deceased's personal representatives,

(b) so far as the tax is attributable to the value of property which, immediately before the death, was comprised in a settlement, the trustees of the settlement;

(c) so far as the tax is attributable to the value of any property, any person in whom the property is vested (whether beneficially or otherwise) at any time after the death, or who at any such time is beneficially entitled to an interest in possession in the property;

(d) so far as the tax is attributable to the value of any property which, immediately before the death, was comprised in a settlement, any person for whose benefit any of the property or income from it is applied after the death."

By section 205, each person liable in respect of inheritance tax is liable for the whole of it.

The liability to pay inheritance tax is to be distinguished from the burden of the tax. The burden of inheritance tax is the ultimate incidence of tax, after the accounting party (ie. the person who has paid the tax to the Revenue) has exercised any right of reimbursement which he may have against a third party, and has exercised any right which he may have to be indemnified out of any property in respect of the tax.

The purpose of this article is to explore the various rights which the accounting party has to recoup the tax he pays in respect of a lifetime chargeable transfer or property subject to a reservation, so that the tax (partly at least) is not ultimately borne by him. As will be seen, the 1984 Act does not deal comprehensively with this subject, and recourse must be had to general principles of common law and equity.

**Express indemnity**

When a transferor makes a lifetime gift, he should consider extracting an indemnity from the transferee in respect of any tax which may become payable by virtue of the transfer. If this is done and the personal representatives of the transferor pay inheritance tax in respect of the gifts, they may recover the tax paid from the transferee under the indemnity. The Revenue has confirmed that such an indemnity will not amount to a reservation of benefit for the purposes of section 102 of the Finance Act 1986.

**Rights conferred on personal representatives by the 1984 Act**

The Act sets out a statutory indemnity in respect of inheritance tax paid by personal representatives in section 211(3) as follows:

"Where any amount of tax paid by personal representatives on the value transferred by a chargeable transfer made on death does not fall to be borne as part of the general testamentary and administration expenses of the estate, the amount shall, where occasion requires, be repaid to them by the person in whom the property to the value of which the tax is attributable is vested."

This subsection is to be read together with subsection (1), which provides:

"Where personal representatives are liable for tax on the value transferred by a chargeable transfer made on death, the tax shall be treated as part of the general testamentary and administration expenses of the estate, but only so far as it is attributable to the value of property in the United Kingdom which:

(a) vests in the deceased's personal representatives, and

(b) was not immediately before the death comprised in a settlement."

There is therefore a twofold requirement before the statutory indemnity in section 211(3) will apply, namely that the personal representatives have paid tax on a chargeable transfer made on death and that such tax does not fall to be borne as part of the general testamentary and administration expenses of the estate within section 211(l).

The loophole in section 211(3) is readily apparent - it will not avail a personal representative where he has paid tax on a chargeable lifetime transfer as he may be required to do where a transferor dies within seven years of making a transfer. This subsection is to be contrasted with the estate duty provision in section 9(4) of the Finance Act 1894, which gave to executors a right to be repaid duty which they paid in respect of any property by the trustees or owners of that property, whether the property was the subject-matter of a gift inter vivos within seven years of death or whether it was disposed of on death (in both cases, the property was "property passing on the death of the deceased" for the purposes of estate duty). In 1987, the Chartered Institute of Taxation made budget representations in relation to this loophole, which it may be observed arose because of the imposition of liability upon personal representatives in respect of lifetime chargeable transfers made after March 14, 1989 by the Finance Act 1986. Sadly, the loophole has yet to be filled.

On the other hand, section 211(3) will usually apply where a personal representative has paid tax in respect of property subject to a reservation. In such a case, the tax will not form part of the general testamentary and administration expenses of the estate within section 211(1) because the property in question never in fact vests in the deceased's personal representatives. However, such property is treated as forming part of the deceased's estate and therefore as part of the chargeable transfer on death. It should, however, be noted that the effect of the Inheritance Tax (Double

Charges Relief) Regulations is that if the original transfer of the property in question is or proves to be a chargeable transfer, and the tax attributable to that transfer is higher than the tax payable under the reservation of benefit rules, tax will be charged only on the lifetime transfer so that section 211(3) will not apply in respect of the tax paid.

It should also be noted that there is no statutory provision providing an accounting party who is the transferee of the property in relation to which the tax is exigible or in whom such property is vested with a right of contribution from other such persons. This, again, should be contrasted with the estate duty provisions, where a right of contribution was provided under the Finance Act 1894, s.14(l).

Section 212(l) of the 1984 Act confers certain powers to raise tax upon an accounting party. It provides:

"Where a person is liable, otherwise than as transferor ... for tax attributable to the value of any property he shall, for the purpose of paying or raising the amount of it when paid, have power, whether or not the property is vested in him, to raise the amount of tax by sale or mortgage of, or a terminable charge on, that property or any part of it."

Further, section 212(2) creates a charge in favour of an accounting party, often called a "limited owner's charge". It provides:

"A person having a limited interest in any property who pays the tax attributable to the value of that property shall be entitled to the like charge as if the tax so attributable had been raised by means of a mortgage to him."

These two subsections have virtually identical estate duty predecessors in section 9(5) and (6) respectively of the Finance Act 1894. However, these subsections are somewhat limited in scope. For example they will not assist an accounting party who pays the tax attributable to a gift of cash, which was immediately paid into a bank account, because “property” does not include its traceable proceeds. To this extent the limited owners’ charge is narrower than the charge in favour of the Revenue contained in section 237, which carries on into replacement property following a sale (see section 238).

**Rights of person acting in representative capacity to reimbursement from beneficiaries**

In 1995, a transferor with a nil cumulative total wishes to create an ordinary discretionary trust for the benefit of his children and grandchildren, and for that purpose transfers 500,000 to his trustees. He pays inheritance tax on the transfer. In 1997, the transferor dies.

The above example represents an extremely common situation. The additional tax due by virtue of the transferor’s death within seven years of the transfer is payable by the trustees under section 199(l)(c) of the 1984 Act. The tax is also payable by the transferor’s personal representatives under section 199(2), but only if it remains unpaid by the trustees 12 months after the end of the month in which the transferor died (section 204 (8)). In either case, the liability is capped by reference to the size of the trust fund or the estate as the case may be (section 204(l),(2)).

Whether the trustees or the personal representatives pay the additional tax due on the transferor's death, the relevant accounting party may pay the tax out of the funds which he holds in that capacity. This position is reinforced in the case of trustees by section 212(3), which gives them an express power to pay the tax out of the trust fund.

How the tax is borne as between the beneficiaries under the trust or of the estate is in the first instance a question of construction of the trust deed or will, although it will also depend upon other factors such as whether any of the beneficiaries are liable to the Revenue for the tax. It should be noted that if the tax is payable in respect of a lifetime chargeable transfer and is paid by the personal representatives, it is not a testamentary expense.

A personal representative stands in a particular position of danger, which is not faced by a trustee in a situation such as that described in the above example. If the personal representative pays tax attributable to property which is the subject-matter of a lifetime chargeable transfer or property subject to a reservation, he will be paying tax in respect of property which never vests in him in that capacity, and the existence of which he may be unaware. Therefore, there is a significant danger that the existence of, for example a failed potentially exempt transfer or property subject to a reservation might emerge after the estate has been administered, which will result in further tax being payable, for which the personal representatives will be liable without having funds in hand to meet the liability. Their clearance certificate may not protect them in these circumstances because of the non-disclosure of the lifetime gift.

Since the introduction of liability of personal representatives in these circumstances by the Finance Act 1986, a number of people have voiced concern over the exposure of personal representatives. These concerns may have been assuaged to some extent by assurances made by the Revenue as to the circumstances in which they will pursue personal representatives for inheritance tax, although personal representatives are still at risk in “an appropriate case” which may include a case where the donee of a lifetime gift is resident overseas without assets in the jurisdiction. It is clearly prudent for personal representatives to extract indemnities from the beneficiaries before distributing the residue, and they even have power to require security for such an indemnity. Other ways in which personal representatives may protect themselves in such a position include taking out insurance against the possibility of the existence of a liability to pay inheritance tax of which they have no notice (their ability to fund this out of the estate will depend upon the terms of the will and the attitude of the beneficiaries) or retaining part of the estate against the possibility of this happening (although this course will be unpopular with beneficiaries). It is obviously extremely important that personal representatives research the affairs of the deceased thoroughly so that the possibility of unknown inheritance tax liabilities is slight, and if they are in a position of doubt they should renounce probate.

If a personal representative discovers the existence of such a tax liability when he does not have funds in hand to meet it, he may bring an action against the residuary beneficiaries to recover the amount overpaid. Personal representatives have an equitable right to recover the tax paid from the overpaid residuary beneficiaries provided that they had no notice of the liability to pay the tax and, it seems on general principles of unjust enrichment they have a right at common law to recover a sum representing overpayments from beneficiaries on the grounds that it was paid under mistake of fact, although both of these rights are fragile because of the developing defence of change of position. This defence would prevent the personal representatives from recovering where the overpaid beneficiary has acted in reliance upon the fact that he was entitled to the overpayment by incurring expenditure which he would not otherwise have incurred.

**Rights of accounting party to reimbursement from other persons liable for the tax**

In 1995, a transferor with a nil cumulative total makes a joint gift to his children X and Y of a house worth 500,000. In 1996, the transferor dies leaving his estate to his wife.

In this example, X and Y are each liable for the tax payable. in respect of the lifetime transfer of the house (section 199(l)(b) and (c)). However, the executors of the will are also liable, although they are only so liable if X and Y do not pay it within 12 months of the transferor's death (sections 199(2) and 204(8)).

Suppose X pays the tax due to the Revenue and seeks a 50 per cent contribution in respect of this payment from Y on the basis that he has discharged a statutory liability which fell upon them equally. As has been observed above, the 1984 Act does not provide any statutory right of indemnity in this case, and the limited owner's charge in section 212(2) will not apply if the house has been sold by the time the tax is paid (because X will not have any interest in the house at the relevant time). X must therefore look to the ordinary principles of contribution in equity.

In the estate duty case of Berry v. Gaukroger, a testator bequeathed his residuary estate to trustees upon trust inter alia to pay an annuity to his widow for life, and subject thereto to pay certain legacies and then to divide the residue between certain named persons. Estate duty became payable on the widow's death, which was paid by the trustees. A question arose as to whether this should be borne solely by the residuary beneficiaries or whether the legatees should pay their rateable portion. The Court of Appeal held that the legatees, being persons who together with the residuary beneficiaries fell within section 8(4) of the Finance Act 1894 (which set out the persons accountable to the Revenue for estate duty payable in these circumstances), should bear a rateable portion of the tax. Cozens-Hardy L.J. remarked (at 134):

"It is true that the Crown, having the right to demand the duty from other persons - namely, the trustees - has not proceeded against the legatees; but that, I think, can make no difference. It is an old and well-established principle of equity that, when several persons are liable in respect of one and the same obligation, the rights of the parties inter se are not affected by the circumstance that one of those persons has been called upon to discharge and has discharged the obligation. This right of contribution must, I think, prevail here; and, although the money has been found out of the entire fund, it ought to be contributed rateably according to the beneficial interests in the fund, or, in other words, the legatees must bear their rateable proportion."

On this basis, X should succeed in his claim against Y. Suppose that instead of the tax being paid by X, it remained unpaid one year after the transferor's death, and was eventually paid by the executors. The executors may wish to pursue X and Y for an indemnity in respect of this tax. An indemnity rather than a contribution will be appropriate in these circumstances, because the liability of the executors is secondary to the liability of X and Y. As has been observed above, section 211(3) will not assist the executors, and in order to succeed against X or Y they must have recourse to the principles of equity.

In Moule v. Garrett, Cockburn C.J., citing a passage from the first edition of Leake on Contracts, stated as follows:

"Where the plaintiff has been compelled by law to pay, or being compellable by law, has paid money which the defendant was ultimately liable to pay, so that the latter obtains the benefit of the payment by the discharge of his liability; under such circumstances the defendant is held indebted to the plaintiff in the amount."

Applying this principle to Example 2, the executors, who have discharged the liability of X and Y to the Revenue under compulsion of law, have a right to recover from them the entirety of the tax paid. Surprisingly, practitioners' texts on this subject assert that a right of indemnity does not exist in these circumstances. This assertion is made without analysis or authority and is, it is respectfully submitted, wrong.

It will be observed that it is extremely important that executors in these circumstances do not pay the tax before the 12-month period from the transferor's death has expired unless requested to by the persons liable, because an essential element for the application of this principle (namely the legal compulsion giving rise to the payment) will be lacking.

If, as is likely on the facts of Example 2, the executors have paid the tax out of the transferor's estate using their right of indemnity discussed above, any action by the executors will be for the benefit of the wife. As the wife does not have any liability to the Revenue herself, she does not, it seems, have any action in her own name. However, she can probably compel the executors to bring their action for her benefit, in which case she should indemnify them in respect of their costs of doing so.

The situations in which the equitable doctrines of indemnity and contribution might be used in this context are too multifarious to catalogue. Where a contribution is appropriate, it should be appreciated that equality is not always equity. Tax attributable to property should be borne pro rata as between persons to whom the property has been transferred or in whom the property is vested. Further, whether it is an indemnity or contribution which is appropriate will depend upon the circumstances. For example if a donee of a lifetime gift of property pays the tax attributable to such property, it is submitted that he would be entitled to be indemnified against the tax from a person to whom he has gratuitously transferred such property, which person is liable to the Revenue as a person in whom the property is vested.

It should be noted that as the right to indemnity or contribution in these cases is based on the existence of the common statutory liability to the Revenue of the accounting party and the person upon whom he seeks to shift all or part of the burden of inheritance tax, the Civil Liability (Contribution) Act 1978 does not apply to the accounting party's claim.

**Final word**

The 1984 Act is woefully inadequate in its provisions concerning who should bear inheritance tax on lifetime transfers. It seems that part of the problem is attributable to the way in which the 1984 Act was amended by the Finance Act 1986, without any consideration being given to these questions either in the House of Commons or in the Standing Committee which considered the Bill. If the Government finds the time in its consideration of capital taxation generally to review these provisions, it could usefully remind itself of the approach taken by the Finance Act 1894, which dealt more comprehensively with this subject. In the meantime, it is submitted that the general principles of the law of restitution are capable of assisting an accounting party in his attempts to redistribute the burden of tax which he has paid.

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