Market Bulletin

LLOYD'S

One Lime Street London EC3M 7HA

FROM:	Head of Taxation
LOCATION:	86/441
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REFERENCE:	Y3204
SUBJECT:	**INHERITANCE TAX: NAMECOS AND FUNDS AT LLOYD'S**
ATTACHMENT:	Annex
ACTION POINTS:	To note
DEADLINE:	None

1. *Introduction*

1.1 A number of earlier market bulletins have dealt with the inheritance tax treatment where Funds At Lloyd's ("FAL") are provided by the owner of a NameCo by way of bank guarantee or third party deposit. Most recently, bulletin Y3161 of 14 October 2003 confirmed that, for individuals who have already converted to a NameCo, the Inland Revenue will by concession allow IHT business property relief on the value of the underlying assets, subject to certain limitations, up to and including 31 December 2004.

1.2 This bulletin deals with the IHT treatment that will apply to all owners of NameCos from 1 January 2005 onwards, if the time limit of 31 December 2004 is not extended and there is no change of tax law in the meantime. This IHT treatment also applies now to any owners of NameCos who did not convert from individual underwriting.

2. *Principles of valuation*

2.1 As noted in bulletin Y2840 of 23 July 2002, IHT business property relief is not in strictness due on assets that are put up as third party FAL or which underlie a bank guarantee that is used as a NameCo's FAL. However, the negative value of such FAL arrangements falls to be taken into account in valuing a deceased individual's estate for IHT purposes.

2.2 In valuing the estate, regard must therefore be had to the degree of likelihood that such assets will be drawn upon to meet the NameCo's losses, whether directly if they are third party FAL or indirectly if they are security for a bank guarantee. In addition, the valuation of the assets needs to take into account the diminution in their value due to the fact that the individual, or his or her estate, does not have unfettered use of the assets during the period of the FAL or guarantee arrangements.

2.3 The practical application of these principles can be quite complex, and so the annex to this bulletin contains some examples illustrating how they will work in practice. The annex also contains some notes explaining the assumptions and the valuation procedures used in the examples.

3 *Readership and contact details*

3.1 This bulletin, which has been agreed with the Inland Revenue, is being sent to underwriting agents, recognised auditors, personal accountants and members who deal with their own tax affairs.

3.2 If you have any queries on it, could you please contact Richard Pester on 020 7327 6727 or myself on 020 7327 5228.

David Clissitt
<u>Head of Taxation</u>

ANNEX

EXAMPLES OF IHT RULES

General Introduction

A1. The following eight examples are intended to show the inheritance tax position where an owner of a NameCo supports the underwriting of the NameCo either by providing assets as contractual support for a bank guarantee in the NameCo's FAL or by providing assets directly as third party FAL. They also consider the situation where there is interavailable FAL.

A2. The names and the figures in the examples are fictitious and are provided for illustrative purposes only. They are not based on particular individuals' circumstances.

A3. Where an individual owns a NameCo, then in valuing the owner's estate for IHT purposes regard must be had to the value of the shareholding in the NameCo, although under current law this will be covered by 100% business property relief (BPR).

A4. For cases where the strict IHT treatment is applied either now or in the future it will also be necessary to determine the negative value of any bank guarantee or third party FAL arrangements to the estate where these support the underwriting of a NameCo.

A5. Where FAL is interavailable, BPR will be given only on the interavailable FAL that is supporting the individual's own underwriting. The value of any excess of interavailable FAL over this amount will fall to be considered in the light of the negative value of the FAL arrangement to the estate (per paragraph A4 above).

A6. The examples given include a case where a bank guarantee is secured on property that qualifies for Agricultural Property Relief. This is to illustrate the point that the Inland Revenue will treat the value of underlying assets as reduced by the amount of the guarantee for the purpose of giving any other reliefs or exemptions. (The same point was made in relation to individual underwriters in Market Bulletin Y2776 of 23 April 2002.)

Detailed Notes

A7. The following notes may help explain the examples.

A8. Shareholdings in NameCos which qualify for 100% BPR are shown as a positive amount but with an equal negative figure for BPR on the shareholding. Where the value is considered to be negligible this is also shown.

A9. It is assumed that normal share valuations and procedures apply. In the examples, the valuation of the shareholding in the NameCo is taken as the net asset valuation of the company on the balance sheet date immediately preceding the date of death, although it should be noted that this may in some circumstances not always be the case.

A10. In reaching the net asset valuation it is necessary to assess the value of Lloyd's open years. Please see the following paragraphs for further notes on this, as it is also needed to assess the negative value of the FAL arrangements to the estate.

A11. To assess the negative value of the bank guarantee or third party FAL arrangement to the estate a two part calculation is needed.

(a) First, the projected amount of drawdowns on the guarantee or FAL must be ascertained by reference to the likely results on open years at the time of death and the available assets within the NameCo to meet any cash calls; and

(b) Second, the remainder of any assets supporting the guarantee or put up as third party FAL that are not expected to be drawn down upon are still not available to the estate in unfettered form during the period of the contractual FAL arrangements, and the negative value of these arrangements must be assessed.

A12. With regard to assessing the projected open years results, for the purposes of valuing the company (paragraph A10) and any projected drawdowns on the FAL (paragraph A11.(a)), the existing basis of valuation may be used. This is explained in Chapter 13 of the Inland Revenue's Lloyd's Manual, which can be accessed at http://www.inlandrevenue.gov.uk/manuals/index.htm , and also in Lloyd's Market Bulletin of 26 May 1995 entitled "Valuation of Underwriting Interest for Inheritance Tax".

A13. In short, the existing basis for valuation of the open year profits or losses referred to above is based on the annual Lloyd's Solvency Statement for the year preceding the year in which the member dies, adjusted for various expenses. This involves discounting the profits or losses in order to arrive at the valuation. There is also an administrative arrangement under which personal representatives may disregard the audit value at death and use the actual profits or losses when they are known to determine the IHT position.

A14. In the examples the likely drawdowns on assets supporting bank guarantees or put up as third party FAL have been reached by using the figure of the NameCo's net realisable assets (e.g. cash or investments) at the last balance sheet date before the date of death. This is compared to the figure of projected losses, and any excess of losses over realisable assets is treated as the projected drawdown figure. There may, however, be other ways of making this evaluation.

A15. The valuation referred to at A11.(b) is of the extent to which the FAL arrangements themselves, after taking account of the likelihood of drawdowns, reduce the value of the estate. In order to do this, the value of the supporting assets or third party FAL (to the extent that they are not expected to be drawn down) will need to be discounted on an actuarial basis the date that they will either be drawn down to meet losses or will become unfettered.

A16. It is Lloyd's practice to require FAL arrangements to be set up for an initial period of 5 years, and then for a rolling 4-year period. The examples therefore reflect this by discounting the supporting assets or FAL assets (to the extent that they are not expected to be drawn down) from the date of death to the projected time of release, which is taken as 3 years after the 31 December following the date of death.

A17. To the extent that the projection of open years results shows that supporting assets or third party FAL is likely to be drawn down, the valuation arrived at in line with paragraph A13 above will already be discounted. It is therefore unnecessary to discount the value of the FAL assets that are expected to be drawn down as this is already a discounted value.

A18. Any remainder of supporting assets or third party FAL should, however, be discounted in valuing the estate, for example using Parry's tables, for the period mentioned in paragraph A16. The examples show the period of discount and an illustrative figure of 10% or 11%, but please note that the figures quoted are for the purposes of illustration only and should not be used instead of properly calculated discounts. They should not be taken as implying either that 10% or 11% is the correct figure in any given circumstances or that a seven-month increase in time will equate to a 1% increase in the discount to be applied.

A19. The principles that apply to third party FAL and to assets supporting bank guarantees also apply to that portion of an individual's interavailable FAL that is not needed to support his or her individual underwriting. This is shown in the final two examples.

A20. The following pages contain eight illustrative examples of how these principles apply. These are:

1. Mr Acorn	bank guarantee and open year losses
2. Mr Block	bank guarantee and open year profits
3. Mrs Caille	third party FAL and open year losses
4. Miss Dos Santos	third party FAL and open year profits
5. Dr Esper	bank guarantee on agricultural property and open year losses
6. Mr Finlay	bank guarantee on other assets and open year losses
7. Ms George	**i**nteravailable FAL with bank guarantee and open year profits
8: Mr Hart	**i**nteravailable FAL with bank guarantee and open year losses.

/…EXAMPLES

IHT: EXAMPLES

1. NameCo with bank guarantee and open year losses: Mr Acorn

1.1 Mr Acorn owns all the share capital of Acorn Underwriting Limited (AU Ltd), an unquoted corporate member at Lloyd's. He does not underwrite on his own account. At his date of death, which is 30 October 2005, his assets, excluding the value of the shares in AU Ltd, total £1,500,000.

1.2 AU Ltd has Funds At Lloyd's of £300,000. These are in the form of a bank guarantee that is secured on Mr Acorn's own assets.

1.3 At the last balance sheet date, which was 31 December 2004, AU Ltd had realisable assets of £25,000. This is not believed to have materially altered between then and the date of death.

1.4 However, the valuation of open years' results shows a deficit of £250,000. The £25,000 of realisable assets will offset only part of this, leaving a deficit with a NPV of £225,000 that will be met by the bank guarantee. Under the contractual arrangements with the bank, Mr Acorn's estate will have to pay this to the bank.

1.5 The value of the shareholding in AU Ltd is therefore only the net assets after deducting the £25,000 expected to be paid out to meet losses. In this example it is therefore assumed to be negligible.

1.6 The £225,000 deficit referred to above has already been discounted to reflect the anticipated dates of payment. It is not therefore necessary to discount £225,000 of the assets supporting the FAL, as £225,000 is the net present value. The remaining £75,000 should, however, be discounted from the date of death up the anticipated date of release, i.e. 31 December 2008. This discount factor is assumed to equal 10% in this example.

1.7 On Mr Acorn's death the IHT calculation is therefore as follows:

	£	
Value of assets	1,500,000	
+ Value of shares in AU Ltd	*	negligible
- Business property relief on AU Ltd	*	(negligible)
- NPV of projected drawdown on guarantee	(225,000)	
- Discount on FAL not used to cover losses (i.e. £75,000 @ 10%)	(7,500)	
NET VALUE OF ESTATE	**£1,267,500**	

IHT: EXAMPLES

2. NameCo with bank guarantee and open year profits: Mr Block

2.1 Mr Block owns all the share capital of Block Underwriting Limited (BU Ltd), an unquoted corporate member at Lloyd's. He does not underwrite on his own account. At his date of death, which is 31 March 2005, his assets, excluding the value of the shares in BU Limited, total £2,000,000.

2.2 BU Ltd has Funds At Lloyd's of £500,000. These are in the form of a bank guarantee that is secured on Mr Block's own assets.

2.3 At the last balance sheet date, which was 31 December 2004, BU Ltd had realisable assets of £40,000. This is not believed to have materially altered between then and the date of death.

2.4 The valuation of open years' results shows a profit of £300,000. Therefore, on a net asset valuation the value of the shares in BU Ltd in this example is £340,000.

2.5 A discount should be calculated on the assets supporting FAL of £500,000. The discount is calculated from the date of death, 31 March 2005, to the estimated release date from the contractual arrangement with Lloyd's, which is 31 December 2008. This is assumed to equal 11%.

2.6 On his death, the inheritance tax calculation is as follows:

	£
Value of assets	2,000,000
+ Value of shares in BU Ltd	340,000
- Business property relief on BU Ltd	(340,000)
- Discount on assets supporting FAL (i.e. £500,000 @ 11%)	(55,000)
NET VALUE OF ESTATE	**£1,945,000**

IHT: EXAMPLES

3. NameCo with third party FAL and open year losses: Mrs Caille

3.1 Mrs Caille owns all the share capital of Caille Underwriting Limited (CU Ltd), an unquoted corporate member at Lloyd's. She does not underwrite on her own account. At her date of death, which is 30 October 2005, her assets, excluding the value of the shares in CU Limited, total £1,500,000.

3.2 The £1,500,000 includes £300,000 which Mrs Caille has provided as Funds At Lloyd's for CU Ltd by way of a third party deposit.

3.3 At the last balance sheet date, which was 31 December 2004, CU Ltd had realisable assets of £25,000. This is not believed to have materially altered between then and the date of death.

3.4 However, the valuation of open years' results shows a deficit of £250,000. The £25,000 of realisable assets will offset only part of this, leaving a deficit with a NPV of £225,000 that will be met from the third party deposit.

3.5 The £225,000 deficit referred to above has already been discounted to reflect the anticipated dates of payment. It is not therefore necessary to discount £225,000 of the FAL, as £225,000 is the net present value. The remaining £75,000 should, however, be discounted from the date of death up the anticipated date of release, i.e. 31 December 2008. This discount factor is assumed to equal 10% in this example.

3.6 On her death, the inheritance tax calculation is as follows:

	£	
Value of assets	1,500,000	
+ Value of shares in CU Ltd	*	negligible
- Business property relief on CU Ltd	*	(negligible)
- NPV of projected drawdown on third party FAL	(225,000)	
- Discount on FAL not used to cover losses (i.e. £75,000 @ 10%)	(7,500)	
NET VALUE OF ESTATE	**£1,267,500**	

IHT: EXAMPLES

4. NameCo with third party FAL and open year profits: Miss Dos Santos

4.1 Miss Dos Santos owns all the share capital of Dos Santos Underwriting Limited (DU Ltd), an unquoted corporate member at Lloyd's. She does not underwrite on her own account. At her date of death, which is 31 March 2005, her assets, excluding the value of the shares in DU Limited, total £2,000,000.

4.2 These assets include £500,000 which Miss Dos Santos has provided as Funds At Lloyd's for DU Ltd by way of a third party deposit.

4.3 At the last balance sheet date, which was 31 December 2004, DU Ltd had realisable assets of £40,000. This is not believed to have materially altered between then and the date of death.

4.4 The valuation of open years' results shows a profit of £300,000. Therefore, on a net asset valuation the value of the shares in DU Ltd in this example is £340,000.

4.5 A discount should be calculated on the FAL of £500,000. The discount is calculated from the date of death, 31 March 2005, to the estimated release date from the contractual arrangement with Lloyd's, which is 31 December 2008. This is assumed to equal 11%.

4.6 On her death, the inheritance tax calculation is as follows:

	£
Value of assets	2,000,000
+ Value of shares in DU Ltd	340,000
- Business property relief on DU Ltd	(340,000)
- Discount on FAL not needed to cover losses (i.e. £500,000 @ 11%)	(55,000)
NET VALUE OF ESTATE	**£1,945,000**

IHT EXAMPLES

5. NameCo with bank guarantee secured on agricultural property and open year losses: Dr Esper

5.1 Dr Esper, a farmer, owns all the share capital of Esper Underwriting Limited (EU Ltd), an unquoted corporate member at Lloyd's. He does not underwrite on his own account. At his date of death, which is 30 October 2005, his assets, excluding the value of the shares in EU Limited, total £1,500,000. The assets include farmland of £700,000 which qualifies for 100% agricultural property relief.

5.2 EU Ltd has Funds At Lloyd's of £300,000. These are in the form of a bank guarantee that is secured on Dr Esper's farmland.

5.3 At the last balance sheet date, which was 31 December 2004, EU Ltd had realisable assets of £25,000. This has not materially altered between then and the date of death.

5.4 The valuation of open years' results shows a deficit of £250,000. The £25,000 of realisable assets will offset only part of this, leaving a deficit with a NPV of £225,000 that will be met by the bank guarantee. Under the contractual arrangements with the bank, Dr Esper's estate will have to pay this to the bank.

5.5 The value of the shareholding in EU Ltd is therefore only the net assets after deducting the £25,000 expected to be paid out to meet losses. In this example it is therefore assumed to be negligible.

5.6 For the purpose of giving the 100% Agricultural Property Relief, the value of the farmland is reduced by the negative value of the bank guarantee.

5.7 The £225,000 deficit referred to above has already been discounted to reflect the anticipated dates of payment. It is not therefore necessary to discount £225,000 of the assets supporting the FAL, as £225,000 is the net present value. The remaining £75,000 should, however, be discounted from the date of death up the anticipated date of release, i.e. 31 December 2008. This discount factor is assumed to equal 10% in this example.

5.8 On Dr Esper’s death, the inheritance tax calculation is as follows:

		Agricultural Property £	Other property £	TOTAL £
	Value of assets	700,000	800,000	1,500,000
+	Value of shares in EU Ltd	-	*	*
-	BPR on shares in EU Ltd	-	(*)	(*)
-	NPV of projected drawdown on guarantee	(225,000)	-	(225,000)
-	Discount on FAL not needed to cover losses (i.e. £75,000 @ 10%)	(7,500)	-	(7,500)
		467,500	800,000	1,267,500
-	Agricultural Property Relief	(467,500)	-	(467,500)
	NET VALUE OF ESTATE	**Nil**	**£800,000**	**£800,000**

IHT: EXAMPLES

6. NameCo with bank guarantee secured on other assets and open year losses: Mr Finlay

6.1 Mr Finlay, a farmer, owns all the share capital of Finlay Limited (FU Ltd), an unquoted corporate member at Lloyd's. He does not underwrite on his own account. All the facts are as for Dr Esper (Example 5), except that the bank guarantee is secured on assets other than the farmland. For the purpose of giving the 100% Agricultural Property Relief, the value of the farmland is not therefore reduced by the negative value of the bank guarantee.

6.2 On his death the inheritance tax calculation is as follows:

		Agricultural Property £	Other property £	TOTAL £
	Value of assets	700,000	800,000	1,500,000
+	Value of shares in FU Ltd	-	*	*
-	BPR on shares in FU Ltd	-	(*)	(*)
-	NPV of projected drawdown on guarantee	-	(225,000)	(225,000)
-	Discount on FAL not needed to cover losses (i.e. £75,000 @ 10%)	-	(7,500)	(7,500)
		700,000	567,500	1,267,500
-	Agricultural Property Relief	(700,000)	-	(700,000)
	NET VALUE OF ESTATE	**Nil**	**£567,500**	**£567,500**

IHT: EXAMPLES

7. Interavailable FAL with bank guarantee and open year profits: Ms George

7.1 Ms George has converted from individual underwriting and owns all the share capital of George Underwriting Limited (GU Ltd), an unquoted corporate member at Lloyd's. At her date of death, which is 31 March 2005, her assets, excluding the value of her personal Lloyd's interest and the shares in GU Ltd, total £2,000,000.

7.2 Interavailable Funds At Lloyd's of £500,000 are in place supporting both Ms George's personal underwriting and that of GU Ltd. They are in the form of a bank guarantee that is secured on her own assets (which are part of the £2,000,000 referred to above). It is assumed that the Inland Revenue accepts that only £200,000 of the interavailable FAL is needed to support the personal underwriting.

7.3 The valuation of Ms George's personal open years' results shows a profit of £75,000. Assume for this purpose that the valuation of her personal underwriting assets at death equals only the £200,000 FAL supporting the underwriting plus the £75,000 open year profit, totalling £275,000.

7.4 At the last balance sheet date, which was 31 December 2004, GU Ltd had realisable assets of £40,000. This has not materially altered between then and the date of death. The valuation of GU Ltd's open years shows a profit of £200,000. Therefore, on a net asset valuation, the value of the shares in GU Ltd in this example is £240,000.

7.5 The £75,000 profit on the personal underwriting is included in the valuation of Ms George's own underwriting business, which is covered by 100% IHT business property relief. £200,000 of the assets underlying the bank guarantee that is needed for her personal underwriting will also be covered by BPR.

7.6 The assets underlying the remainder of the bank guarantee (i.e. £300,000) should be discounted from the date of death, 31 March 2005, to the estimated release date from the contractual arrangement with Lloyd's, which is 31 December 2008. This is assumed to equal 11%.

7.7 On Ms George's death, the inheritance tax calculation is as follows:

	£
Value of assets (excluding £200,000 personal FAL)	1,800,000
+ Value of own Lloyd's interest (see 7.3)	275,000
- BPR thereon	(275,000)
+ Value of shares in GU Ltd	240,000
- Business property relief on BU Ltd	(240,000)
- Discount on assets supporting balance of FAL(i.e. £300,000 @ 11%)	(33,000)
NET VALUE OF ESTATE	**£1,767,000**

IHT: EXAMPLES

8. Interavailable FAL with bank guarantee and open year losses in the NameCo: Mr Hart

8.1 Mr Hart has converted from individual underwriting and owns all the share capital of Hart Underwriting Limited (HU Ltd), an unquoted corporate member at Lloyd's. At his date of death, which is 30 October 2005, his assets, excluding the value of his personal Lloyd's interest and the shares in HU Ltd, total £1,500,000.

8.2 Interavailable Funds at Lloyd's of £300,000 are in place supporting both Mr Hart's personal underwriting and that of HU Ltd. They are in the form of a bank guarantee that is secured on his own assets (which are part of the £1,500,000 referred to above). It is assumed that the Inland Revenue accepts that only £50,000 of the interavailable FAL is needed to support the personal underwriting.

8.3 Assume for this purpose that the valuation of Mr Hart's personal open years' results shows no profit and no loss and that the valuation of his personal underwriting assets at death equals only the £50,000 FAL assets supporting the underwriting.

8.4 At the last balance sheet date, which was 31 December 2004, HU Ltd had realisable assets of £25,000. This has not materially altered between then and the date of death. However, the valuation of HU Ltd's open years shows a deficit of £200,000. The £25,000 of realisable assets will offset only part of this, leaving a deficit of £175,000 that will be met by the bank guarantee. Under the contractual arrangements with the bank, Mr Hart's estate will have to pay this to the bank.

8.5 The value of the shareholding in HU Ltd is the net assets after deducting the £25,000 expected to be paid out to meet losses. It is therefore assumed to be negligible.

8.6 The valuation of Mr Hart's own underwriting business, including the no profit/no loss on open years and the assets underlying the £50,000 bank guarantee accepted as being used for personal underwriting, is covered by business property relief.

8.7 The total amount of the bank guarantee assets was £300,000. As noted above, £50,000 is accepted as forming part of the valuation of the personal underwriting interest, leaving a balance of £250,000. Of these, assets with a net present value of £175,000 will be drawn down by the bank as security for its payment under the bank guarantee, which will reduce the value of the estate by that amount. The remainder of £75,000 assets which are not expected to be drawn down should be discounted from the date of death up the anticipated date of release, i.e. 31 December 2008. This discount factor is assumed to equal 10% in this example.

8.8 On Mr Hart's death the IHT calculation is therefore as follows:

	£	
Value of assets (excluding £50,000 personal FAL)	1,450,000	
+ Value of own Lloyd's interest (see 8.3)	50,000	
- BPR thereon	(50,000)	
+ Value of shares in HU Ltd	*	negligible
- Business property relief on HU Ltd	*	(negligible)
- NPV of projected drawdown on guarantee	(175,000)	
- Discount on FAL not used to cover losses (i.e. £75,000 @ 10%)	(7,500)	
NET VALUE OF ESTATE	**£1,267,500**	