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Inheritance Tax: change to come?

'Almost uniquely unpopular' and 'complicated' were just two of the comments about Inheritance Tax (IHT) made by the Office of Tax Simplification (OTS) recently.

Proposals for change

The latest OTS report on IHT sets out far-reaching suggestions for reform, particularly in the area of lifetime gifts, and around the interaction of IHT and capital gains tax (CGT). Whilst it is uncertain which suggestions the government will act on, with the tax clearly in transition, this is an appropriate time to review family circumstances and aspirations. We focus here on topics highlighted by the OTS, pinpointing opportunities which currently exist to pass wealth to the next generation, and areas worth reconsideration in the light of the OTS report.

IHT: the facts and figures

IHT can come into play when someone has died, being charged on the value of assets after all liabilities have been settled. It is also charged on some lifetime gifts. Many executors and families struggle to understand if IHT will affect them. Fortunately, such worries can be allayed in many cases. The tax in fact impacts very few estates: fewer than 25,000 estates are liable to IHT annually. But more than ten times this number are required to submit IHT forms, even though there is ultimately no tax liability.

- Gifts between UK-domiciled spouses (married couples and registered civil partners) are generally exempt from IHT. This applies to lifetime gifts and gifts on death.
- Each individual has a 'nil rate band' (NRB), chargeable at 0%, taking a slice of the estate out of tax. This is £325,000 for 2019/20. There is also an additional NRB, sometimes called the residence nil rate band, which is being phased in. It applies to deaths on or after 6 April 2017 and can be used to pass an interest in a qualifying residence to direct descendants. It is £150,000 in 2019/20, rising to £175,000 in 2020/21. The rate is effectively doubled for many married couples and registered civil partnerships.
- Whilst the rate of IHT on death is 40%, the treatment of lifetime gifts is different – and potentially complex (see below).
- Where 10% or more of a net estate (after IHT exemptions, reliefs and nil rate band) is left to charity, the IHT rate is 36%.
- IHT is usually paid out of funds from the estate, rather than by the beneficiaries. Recipients of lifetime gifts, however, are currently liable for any IHT due.

Planning to pass wealth on

Much estate planning hinges on the use of lifetime gifts: either by giving to individuals or by transfer into a trust. Current planning areas include:

Lifetime gifts to individuals

Under current rules, lifetime gifts to individuals made more than seven years before death, usually escape tax. Such gifts are potentially exempt under the seven-year rule, becoming chargeable if the donor dies within seven years and if more than £325,000 is given away during that period. Any gifts into trust within seven years before the gift to an individual must be taken into account, as well. Where death occurs within seven years, IHT may still be saved, since the charge is currently based on value at the time of gift, rather than at death.

The interplay of lifetime gifts and NRB is complex. Just how complex is not always appreciated by donors or recipients: NRB is allocated to lifetime gifts in the order in which made chronologically, and is applied to the death estate only to the extent that it is not already allocated to lifetime gifts. This can sometimes create consequences not intended by the donor, with regard say, to the amount beneficiaries receive.



Gifts into trusts

Significant lifetime giving will often use trusts. Gifts into trust may result in an IHT liability, depending on the nature, timing and terms of the gift,

and the value of other chargeable lifetime transfers in the preceding seven years. Trusts mean a recipient does not need to have complete control of the asset or income generated. Lifetime trusts are frequently used to maximise use of NRB: there should be no IHT to pay where the value of assets in the trust, and any gifts within the previous seven years, is below the NRB. NRB may be available for such transfers every seven years: we would be pleased to advise on NRB planning and efficient gifting.

Use of annual exemption

At present, gifts to a total of £3,000 each year are covered by the annual exemption: there is no IHT charge. Any unused annual exemption can be carried forward, for one year only, and must be used in the tax year immediately following.

Small gifts and gifts on marriage or civil partnership

In addition to the annual exemption, any number of small gifts can be made, to a limit of £250 per person in a tax year.

On the occasion of marriage/civil partnership, up to £1,000, per person, per tax year can be given. Higher limits apply for children (£5,000), grandchildren and great-grandchildren (£2,500).

Normal expenditure out of income

There is a valuable exemption for gifts made out of income (not capital). These must not detract from the giver's standard of living, and must form part of their 'usual' expenditure.

Family maintenance and gifts to charity

Gifts can be made for family maintenance without an IHT charge: gifts for children's education, or for the maintenance of a dependent relative, for example. Gifts to registered charities and political parties are exempt.

OTS proposals: lifetime gifts to individuals

These OTS recommendations attracted much media coverage, particularly the proposal to cut the seven-year gifting period to five years. This would exempt from IHT gifts to individuals made more than five years before death. Other proposals include an overall personal gifts allowance, set at a higher – at this point unquantified - level than present reliefs. This would replace various existing exemptions, such as annual gift exemption, exemption for gifts on marriage/civil partnership, and possibly the normal expenditure out of income exemption. The OTS also suggests reconsidering the allocation of NRB to lifetime gifts to individuals, and changing liability for payment of tax, possibly making the estate, rather than recipient, liable. To discuss the implications of such change, or how to maximise the potential of current reliefs and exemptions, please do get in touch.

IHT and Capital Gains Tax

The interaction of IHT and CGT can mean that tax, rather than business needs, dictates the timetable for passing business and agricultural assets between generations. Key here is 'capital gains uplift'. Under current rules, CGT uplift means someone inheriting an asset is treated as acquiring it at market value at date of death, with any gain of the deceased wiped out. It could then be sold soon after without CGT being due. And where an IHT exemption (such as spousal exemption), or relief (such as Business Property Relief (BPR) or Agricultural Property Relief (APR)), applies, there is the potential to escape both IHT and CGT.

This, as the OTS reports, can lead to one generation retaining assets until death, rather than making lifetime transfers. It suggests CGT uplift should be removed where a relief or exemption from IHT would come into play. A recipient would, instead, be treated as if acquiring the asset at the historic base cost of the deceased. This is one of the most radical of the OTS proposals, and would impact significant numbers

of taxpayers. If it goes ahead, some reshaping of succession planning may be necessary, with lifetime gifting coming more to the fore.

Business Property Relief and Agricultural Property Relief

BPR and APR are designed to prevent a business being sold or broken up to settle an IHT bill. BPR can provide 50% or 100% relief on the value of the business for lifetime gifting or transfer on death. But the rules around what constitutes a 'business' activity - as distinct from an 'investment' activity - can cause problems. Those owning holiday letting businesses; estates which combine farming activities with property letting; and caravan parks, amongst others, can find that the availability of IHT relief is far from straightforward.

APR and BPR may both apply to farms, but APR can be wider in scope, potentially applying to farmhouse and to let land. Relief can be 100% but only on the agricultural value. We should be delighted to provide in depth advice here.

Two welcome suggestions from the OTS include:

- reviewing the eligibility of farmhouses for APR in sensitive cases, such as those where a farmer leaves for medical treatment or goes into care
- providing clearer HMRC guidance on when a business requires valuation, and if so, whether a formal valuation or estimate is expected.

Level of trading activity

Under current IHT rules, BPR is available both for lifetime transfers and transfers on death, if a business is 'wholly or mainly' a trading business, rather than an investment business. This is not defined in the legislation, but is usually taken to mean a greater than 50% trading level. Current CGT rules for lifetime gifts, however, set a higher hurdle. To access CGT relief requires 'substantial' trading activity, generally taken to imply an 80% level. This applies for gift holdover relief on the lifetime gift of a business to an individual, or entrepreneurs' relief, on the sale of a business to a third party. On death, the picture changes, CGT uplift coming into play, the trading requirement falling out. There is thus a disparity between the two regimes as regards lifetime gifting and transfers on death.

The OTS suggests setting the BPR threshold for trading activity at the same - higher - level as gift holdover relief and entrepreneurs' relief, and removing CGT uplift on death when APR or BPR are claimed.

Furnished holiday lettings

Furnished holiday lets are treated as a trade for income tax and CGT, but not for IHT purposes. This usually precludes access to BPR: though businesses very occasionally succeed, as in one recent tribunal case, where the owner provided a level of service akin to 'a family run hotel'. The OTS suggests bringing the IHT position into line with income tax and CGT. Allowing furnished holiday lets to access BPR could facilitate transfer of such businesses to the next generation.

Life assurance and pensions

The OTS recommends that death benefit payments from term life insurance be free of IHT on the death of the life assured - without having to be written in trust. Whilst not making specific recommendations on pensions, it notes the anomaly that some pensions policies are included within an estate for IHT purposes whilst others are not, and suggests that a future review would be appropriate.

How we can help

The OTS report brings the likelihood of change to the IHT regime a step closer, and it may be that your plans for the future should be reviewed in this light. We should be delighted to discuss the best way forward for you, your family and your business.