

PRACTICAL INHERITANCE TAX PLANNING: AN OVERVIEW

by Michael Thomas

Introduction

The recent property boom has increased the importance of inheritance tax (“IHT”) for a great many people. Accordingly, IHT planning is probably more important now than ever before. Good tax planning should be simple. IHT primarily operates to charge the value of a person’s estate on death, so the best planning is to give away all your wealth and hope that you survive for another seven years (in order to avoid the deathbed gifts rule). The nil rate band allows £250,000 per person or £500,000 per married couple to be retained until death, free of IHT.

The Problem (for Most People)

Unfortunately most people cannot simply give away their wealth in excess of the value of the nil rate band because they need houses to live in and investments to live off! Another reason why people might not be able to simply give away assets is because they are pregnant with chargeable gain and a gift will trigger a capital gains tax (“CGT”) charge; this is commonly the case with investment properties. It is worth noting at this point that IHT operates unfairly because the very rich can more easily avoid it by giving surplus wealth away whereas the middle class will need all or most of their wealth to live off. For example, a person worth £100

million can give the vast majority of her wealth away and live very comfortably indeed. Whereas a person worth £1 million living in a house worth half that has much less scope for making gifts.

Maximising Use of the Nil Rate Band

It is important that married couples plan to take advantage of both nil rate bands rather than only a £250,000 exemption on the second death. If the surviving spouse will require all the assets then a nil rate band will trust might be used. Care will need to be taken to ensure that the surviving spouse is not treated as having an interest in possession in the assets subject to the will trust. Various techniques are used in order to try and achieve this.

More Sophisticated Planning

If the clients have given away what they wish to and, in the case of a married couple, suitable nil rate band planning is in place, then more sophisticated planning might be considered to further mitigate IHT. Unfortunately, there are a number of problems and no magic solution. The good news is that there is usually something that can be done if the clients wish to pursue it.

The major obstacle is the gifts with reservation (“GWR”) rules contained in the Finance Act 1986 (as amended). These are designed to prevent people giving assets away whilst continuing to benefit from them free of IHT. Those who have encountered these rules will

know that they are complicated and that they have been amended to counter the effect of earlier planning. Most planning continues to focus on the family home. Property law concepts are used to allow taxpayers to retain ownership of the property during their lifetimes but to reduce its value for IHT. Unfortunately, the GWR rules have been amended to focus on exactly this sort of planning with the result that it is ever more difficult. I shall now introduce some of the current planning ideas.

Eversden Arrangements

The GWR rules do not apply to gifts between spouses. Accordingly, if I gift property into a life interest trust for my wife then the GWR rules do not apply. The gift of the reversion is immaterial, because reversionary interests are ignored to IHT purposes. If my wife's life interest is subsequently terminated by the trustees in favour of the children (or a trust in their favour) then that is not a *gift* by her, and accordingly the GWR rules do not apply to that transaction. The result is that we can give away our house to the children and continue to live in it free of IHT. Lightman J recently approved this type of planning in *IRC v. Eversden* [2002] STC 1109. It is the current "hot" planning idea. The Revenue are appealing the decision. Should they lose, or possibly in this year's Finance Act anyway, the Revenue will undoubtedly enact legislation to prevent these structures being used. Importantly, this arrangement can also be used to put investments into a discretionary trust, in which the husband or wife or both of them may be interested. The terms of the trust may make the

arrangement effectively reversible should the Court of Appeal find for the Revenue or the structure's effect is counteracted by retrospective legislation.

Home Loan Schemes

This is a very popular scheme. Essentially, the transferor sells her house to a trust in which she has an interest in possession in exchange for a loan note redemption of which is deferred. The loan note is then given away. The house remains in her estate by virtue of s.49, but the value of the estate is reduced by the value of the loan note. Although these transactions are quite artificial, in my view they do work – but the tax analysis is very complicated. Meanwhile the Revenue are understood to be preparing a test case to challenge them. That is not of itself a reason not to use this structure, because if the Revenue lose in the courts then any anti-avoidance legislation is unlikely to be retrospective. Home loan schemes also raise a CGT problem because the *loan note increases in value* as its date for payment approaches. This might be overcome with careful planning, although it does raise further complications.

Reversionary Lease

This is the opposite of the scheme which was approved by the House of Lords in *IRC v. Ingram* [1999] STC 37 but subsequently countered by the enactment of s.102A FA 1986. In this version, the taxpayer retains the freehold but gives away a long (999 year) lease to take effect within 21 years. Only the rapidly diminishing value of the freehold is then left in the taxpayer's estate.

However, again this scheme raises a CGT problem which arises from the low base cost of the lease.

Lease for Full Value

This is a good scheme for elderly clients with surplus cash. Leases bought for full market value are not caught by the GWR rules. Accordingly, an elderly client can give away her house, buy back a lease for life for a premium and continue living there IHT free. The downside is that income tax is payable on the premium, although no IHT will be payable on it if she dies within 7 years because it is a payment for the lease rather than a gift.

Utilising The CGT Holdover Relief In Section 260 Taxation of Chargeable Gains Act 1992 To Give Away Assets Pregnant With Chargeable Gains

Lifetime transfers chargeable to IHT benefit from CGT holdover relief under s.260 TCGA. Although the transfers are chargeable to IHT, none is actually payable if sufficient nil rate band is available. So, for example, if a person gives away an investment property worth £240,000 into a discretionary trust this can be done with neither a CGT nor an IHT charge.

A scheme was available to allow property in excess of the value of the nil rate band to be placed into discretionary trust without an IHT charge. The Court of Appeal upheld this in *IRC v. Melville* [2001] STC 1271. Legislation was enacted in the 2002 Finance Act to reverse the effectiveness of that decision (the new s.55A

Inheritance Tax Act 1984). Although this is a relatively recent decision, practitioners have developed ways of overcoming the restrictions imposed by s.55A, by utilising fixed interests rather than powers.

Conclusion

I hope that the above gives some flavour of the IHT planning that is available. Unfortunately, there are no magic solutions. Accordingly, what planning, if any, is appropriate will depend upon the particular client's situation. None of the structures are guaranteed successes and each has downsides. On the other hand there are potentially some very large savings to be made with little or no downside if the planning does not work. In my experience the decisive factor is how concerned the individual client is to save IHT. There is usually something that can be done, but the owner of the assets will decide whether or not it is worth the effort, depending how concerned he is to benefit other people free of IHT.