My claim for your tax bill

Malcolm Gunn and Fred Butler show how an individual can obtain relief for tax they never paid.

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Many people do not relish paying tax bills, but some taxes are higher up the unwanted list than others. Probably top of the list is inheritance tax (IHT), pipping stamp duty land tax at the post. Whether it is in lifetime or on death, IHT is seen as an unfair tax on generosity where much of the value has already paid tax. However, in terms of tax planning, an IHT charge can sometimes offer possibilities of reducing overall tax.

As a simple example, suppose a husband and wife jointly own all the shares in an investment company holding properties worth £1m and the shares have minimal base cost. This is not as unlikely as it may seem because on good advice the company may have been funded with a director's loan account which has since been repaid out of profits.

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So now they are left with a valuable company and shares full of capital gain. There will be valuation discounts, but theoretically if they plan to give their shares to their adult children a capital gains tax (CGT) bill of up to 20% of £1m may be incurred; an amount of £200,000. If, however, they have their full IHT nil bands available, the shares can be transferred to a trust for the children with the gain held over. The IHT charge would be £350,000 at 20%; so the tax to pay is £70,000.

To preserve this advantage they must survive the gifts for seven years but a direct gift carries the same IHT risk for that period. Of course, there is the drawback that the gains have not gone away, they are simply held over, but for a family investment company that might not matter.

Key points

- Inheritance tax is seen as an unfair tax on generosity where much of the value has already paid tax and tax planning can offer possibilities to reduce it.
- A gift of shares, for example, may be made into a trust with the gain held over. If the donors have their full inheritance tax nil bands available, the IHT payable can sometimes be less than the CGT on a direct gift without hold over.
- Although the legislation gives primary liability for the IHT on the donee, very often the tax is paid out of the estate.
- If it is a gift of business assets, there are many circumstances where business property relief may have applied on a lifetime gift but ceases to be available if the transferor dies within seven years. The liability can be very substantial.

IHT deduction from the gain

There is an additional benefit with the trust route which is not commonly identified. Since the transfer to the trust is a chargeable transfer, it falls within TCGA 1992, s 260. If you scroll through that section as far as subsection 7 you will find that there is an unusual provision which provides that any IHT paid on a chargeable transfer of an asset which is not also a potentially exempt transfer, is to be deducted from any gain on that asset realised subsequently by the transferee, although not so as to turn it into a loss. This does not require a claim, it's a statutory deduction.

In case of the gift to the trust by the husband and wife, they would normally have arranged for the trustees to pay the IHT due, otherwise the chargeable transfer is grossed up IHT purposes. The tax can then be paid in ten yearly instalments.

On this basis, it might make sense that the trustees can then have relief for the tax they pay as a cost incurred to acquire the shares. In fact, s 260(7) is not limited in this way and it is not relevant who pays the IHT. The trustees can still claim a deduction for the tax even though they never paid it. This must be one of the rare cases of getting relief for somebody else's tax bill.

Winding up the trust

After a period of time, the trustees may decide to terminate it and pass the shares out to beneficiaries, once again with holdover relief. There will be an exit charge for IHT purposes on this event although the amount can be relatively small given that the maximum IHT rate on relevant property trusts is 6%. The exit charge is within the definition of chargeable transfer for inheritance tax purposes (IHTA 1984, s 2(3)) so once again s 260(7) operates and the beneficiaries can have a credit for the IHT paid by the trustees against the capital gains which they will realise if they dispose of the shares themselves.

In planning terms, therefore, even if the beneficiaries want cash it can be better for them to take the shares and sell them. For some odd reason, the trustees cannot claim credit for their own IHT exit charge against the capital gain on transfer out of the trust, but the beneficiaries can when they sell the shares. Unfortunately, there is no similar relief against the income tax charge on the encashment of a single premium bond.

Those beneficiaries cannot however claim any deduction for the IHT which was paid when the trust was made because they were not the transferee relation to the disposal by the settlor. But the trustees are entitled to the deduction against the gain when the shares are transferred out of the trust. They should therefore keep a record of the settlor's inheritance tax liability (if any) when any asset was put into the trust so that they can bring this account into account in calculating the gain on subsequent disposal.

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Where no holdover applied

Suppose that the settlors for some reason had no gain on the asset which they put into the trust. They will not therefore claim any holdover relief and s 260 itself does not apply. Surprisingly, this does not matter in terms of s 260(7).

All that matters is that there was a chargeable transfer and that some IHT was incurred by the transfer. The transferee is entitled to a deduction for IHT against the capital gain which he or she makes on the disposal.

What this really means is that s 260(7) is in the wrong place in the Act. It has nothing to do with held over gains and is a freestanding relief for IHT against CGT. The relief still applies even if there was a loss on the disposal to the trust and no holdover claim was made by the settlor.

Furthermore, it was reported in this magazine, in 1989, that full credit for IHT paid is allowed against a subsequent part disposal although whether or not that practice still applies is not recorded in the manuals. In any event, it would seem unlikely that it would apply to a part disposal from a shareholding.

Gifts of business assets

There is a parallel holdover relief in TCGA 1992, s 165, this time relating to business assets, including shares in trading companies. This contains a similar provision to that in s 260 but, as is typical of our tax legislation, it has a slight variation which gives an important difference.

The relief is at s 165(10) and applies to any disposal to which s 165(4) applies; this is the subsection dealing with a claim for s 165 relief. This means that unless there was actually a holdover claim under s 165, the IHT relief in subsection 10 does not operate.

This will not matter for all transfers into trust because s 260 takes priority over s 165. But in relation to a gift of business assets to another individual, this will be a potentially exempt transfer and so by definition falls outside the scope of s 260. So the relief in s 165(10) is designed to operate in cases where there is a potentially exempt transfer and then subsequently IHT becomes payable because the transferor dies within seven years.

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Business property relief

It might be thought that if it is a gift of business assets, due to business property relief (BPR) there will not be any IHT anyway so what's the problem? The answer to that is that there are many circumstances where BPR may have applied on a lifetime gift but ceases to be available if the transferor dies within seven years. The liability can be very substantial.

A prime example is a gift of land used in a business conducted by the transferor. Under the decision in *Nelson Dance Trustees* [2008] STC SCD 792 this gift qualifies for business property relief, because the value transferred is attributable to the net value of the business. But for the transferee, unless they are involved in the business no business property relief will apply going forward. In the event of the death of the donor within seven years, the BPR is retested as if it were a claim by the transferee at the time of the death and the relief can be withdrawn at that stage.

There will be other situations where BPR ceases to be available, such as where the business no longer exists at the time of the death or where it has changed its nature into an investment business.

One situation where it does not matter that the business has ceased, is in relation to a gift of shares in an unquoted trading company. There is a specific provision in IHT which states that the relief is not withdrawn if the company ceases to be a trading company.

In the case of property used by a partnership or a company controlled by the transferor, business property relief is at only 50% so IHT can also arise in those cases.

Holding over a non-existent gain

Once a holdover claim is made, s 165 gives the transferee an entitlement to deduct the IHT which is payable on the lifetime gift in the event of the death of the transferor. The deduction is given from any gain subsequently realised on the gifted asset.

Although the IHT legislation gives primary liability for the IHT on the donee, very often the tax is paid out of the estate either because the donee simply doesn't pay it in which case HMRC pursue the executors, or because there is a specific provision in the will to this effect. However, it does not matter who pays the tax, the deduction is still available against the subsequent capital gain.

There may be cases where no capital gain arises so no holdover claim is required. Extraordinarily, the best advice is that a claim should nevertheless be made. This will be completely pointless for CGT purposes because there is no gain, but this will bring the allowance against the transferee's capital gain into operation.

This claim may baffle clients, including HMRC, and the transferor might not be very pleased to hear that people are making plans ahead of his death within seven years. However the hold over is necessary to allow the transferee to claim a deduction for what could be a substantial IHT liability on the transferor's death.

Tax is full of these oddities which presumably is what keeps us all interested in the whole topic. ●

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