

Sheltering investments from inheritance tax

by Julie Butler

With property prices having increased so much in recent years and with most houses exceeding the nil rate band for inheritance tax (IHT), there is great concern over sheltering private investments (and possibly property) from IHT in the small family company.

Inheritance tax business property relief (BPR) is a complete exemption from IHT and can be secured on circumstances where it might not be expected to be found – in the owner managed business (OMB).

Investments, property and portfolios

Historically claims for BPR have not been based on how much work is put in by the taxpayer over the years to generate the wealth now being taxed.

Inheritance Tax Act 1984 (IHTA 1984), s. 105 (3) states:

'A business or interest in a business ... are not relevant business property if the business ... consists wholly or mainly of one or more of the following, that is to say, dealing in securities, stock or shares, land or buildings or making or holding investments'.

Case history has focused on the latter element of the 'making a holding investment'.

The basic rule for investments and IHT is straightforward. The business does not qualify for BPR if it 'consists wholly or mainly of ... making or holding investments'.

So how can an OMB be used to shelter securities, land and 'holding investments' for IHT purposes?

The taxpayer owns a family trading company (an OMB). When the taxpayer dies the taxpayer's shares in the company can be passed onto the next generation completely intact. That is because there will be no IHT to pay on these shares, thanks to 100% business property relief (BPR).

If the taxpayer also owns a substantial portfolio of quoted shares, these unfortunately, will eventually fall into the IHT net outside the OMB.

The taxpayer can consider the transfer of this portfolio of shares into the OMB. It is likely that there will be little or no capital gains tax (CGT) to pay on the transfer because, as a result of the stock exchange ups and downs of recent years, the portfolio has a large risk of a profit. (Alternatively, if a few of the shareholdings do show substantial inheritance gains, perhaps these could be left out of the transfer so as to avoid the CGT that would otherwise arise). The other side of the transaction is the director's loan account. This does leave a director's loan account to draw from tax-free.

Protection for existing OMB investments

It could be that investments are not currently held outside the company. However, the company has surplus funds that have been generated at the retained profit tax rate of only 19%. Investments could be purchased by the company or it could be that investments have already built up.

The portfolio (or so much of it as is transferred to the company) or other investments become eligible for business property relief (BPR) in full in the correct circumstances.

Investments inside an OMB

When it comes to shareholdings held in family companies (OMBs) the IHT BPR rules are surprisingly generous. Provided that the business of the company is one of mainly trading – in particular, it does not fall foul of the 'wholly or mainly investment' rule mentioned above – relief is given in full at 100%.

It is essential to ensure that the trading side of the company's business remains more valuable than its investment side. But that is all. If the company is 60% trading and 40% investment, the family company's shares qualify for 100% BPR. Most importantly, the entire value of the shares qualify not just 60% of their value. However, the CGT rules may restrict this to up to 20% of the whole for planning purposes.

Capital gains tax

Capital gains tax may restrict this advantage by up to 20% of the whole of the business for planning purposes. Having investments in the OMB can cause problems if the shares are to be gifted (and holdover relief utilised) or sold (and business asset taper relief (BATR) utilised).

Having investments in the OMB can cause problems if the shares on the family company are to be gifted.

- Capital gains tax 'holdover' relief. This relief applies when shares in a family trading company are given away. (Without the relief, the shares are deemed to be disposed of at market value and as a result a substantial CGT charge could be triggered.) However, if the company owns some non-trading assets – such as stock exchange investments – the amount of 'holdover relief' is reduced proportionately.
- Capital gains tax BATR. A small amount of non-trading activity is permitted – up to 20% – but that is all. Thus, if 40% of the value of the company is represented by investments, the proportion of the share that will qualify for BATR, will also reduce proportionately.

The key can be to restrict the holding of investments to less than 20% to protect the potential IHT and CGT relief.

Cash balances

Is the IHT relief achieved on cash balances? Generally speaking, cash on deposit does not rank as part of a trading business. So BPR is likely to be denied on the proportion of the value of the OMB's shares that is represented by cash on deposit.

What are the considerations?

If the value of the investment transferred into the OMB causes the 20% test to fail, then BATR will indeed be forfeited.

Two-year ownership rule

What of the two-year rule for IHT?

When the taxpayer transfers investments into the company, presumably BPR for these investments does not begin immediately because of the two-year rule?

There is the IHT rule, which says that BPR does not apply until an asset has been owned for at least two years. The asset here is the shareholding in the 'mainly' trading company. So, provided that the shareholding in the trading company has already been owned for at least two years, then relief for the value of the investments which have recently been introduced into the company (and therefore have increased the value of the company) becomes available immediately.

Business property relief applies to the whole of the company provided it meets the trading criteria and the two-year rule for the new investments can be overlooked.

Controlling existing problems

Many OMBs can build up investments without realising that they are investments. Classic examples would be a farmer who starts to let out more and more cottages – see *Farmer*¹. In this case BPR was allowed on 22 let cottages. This was not a limited company and the theme was of unified management. Four areas looked at here were: the extent the proprietor and his employees were engaged in each activity; the time spent by the employees and consultants; capital employed by the farm; and the contribution of each activity to the overall profit of the single business.

Other examples (of investment building) could include where former trading premises are let, e.g. a manufacturing business with surplus space lets its premises as 'an investment'. Could this mean that BPR has been lost because they push the OMB into making a holding investment company?

A key factor here is that – as a result of *Finance Act 2003*, s. 160 – let property qualifies for BATR from 6 April 2004. This could place the OMB in a dilemma. Would it be better to leave the let investment property in the limited company to achieve IHT shelter, but forsake future BATR?

What of the position of stamp duty land tax (SDLT)?

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Fax: +32.2.672.75.14; e-mail: jmcougnon@skynet.be

Tax planning opportunity

It is not often that the opportunity arises to secure a complete exemption from IHT on pure investments – such as a portfolio of stock exchange securities.

It is essential to ensure that the value of the investments does not outweigh the trading activity. The company must at all times remain a 'mainly' trading company – the value of that activity must always be more than 50% trading rule.

In summary, if OMBs do decide to look at the investment angle, the directors must monitor development. If the value of the investments increases substantially, the trading company could become an 'investment' company. Die at the wrong time and the next generation will find that they have inherited a 'mainly investment' company instead of a 'mainly trading' company and that a skilfully converted asset, which once attracted 100% BPR has become one that attracts no relief at all for IHT.

The key appears to be the 20% rule – thus protecting IHT reliefs and BATR.

Julie Butler, FCA, runs her own practice, Butler & Co. Telephone 01962 735544; e-mail – j.butler@butler-co.co.uk

¹ *Farmer (Farmer's Executors) v IR Commrs* (1999) STC (SCD) 321.

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