

Snakes and ladders



Julie Butler discusses the impact of the IHT threshold on average households

With the inheritance tax (IHT) threshold (nil-rate band – NRB) remaining at £283,000 and house prices increasing at a higher rate than the increase to the NRB over the past decade, more and more taxpayers worry about how they might become potentially caught in the IHT trap.

Lack of awareness

Many of those liable to IHT, or possibly having to pay IHT at sometime in the future, have little knowledge of the tax system, for example, where the deceased did not produce a tax return, or did not use a professional adviser, or did not have a will. Despite campaigns in the popular press, there is still a lot of ignorance about exactly what IHT is and how taxpayers can protect both themselves and their family home. The aim of this article is to highlight the potential IHT relief advantages and explain some of the problems caused by the IHT monster.

Surviving spouse exemption

Money gifted to the spouse or civil partner during life or on death is exempt from IHT, which means that the surviving spouse often becomes the "IHT-vulnerable person". Planning should be undertaken to ensure that maximum use is made of the valuable IHT relief of the surviving spouse exemption.

Nil-rate band

In the current tax year, the first £283,000 of a tax payer's wealth is subject to NRB IHT. Amounts higher than that limit are subject to 40 per cent IHT.

If the deceased leaves all the wealth to the spouse under the will, then an unused NRB exists. The key for utilisation lies in a NRB trust, dealt with at the will drafting. In many cases, this involves the houses.

Valuation

The house is usually one of the largest assets in the IHT calculation and must be valued. HM Revenue and Customs might use this as an opportunity to enthusiastically try and collect more tax in good faith.

The house must be valued in accordance with the correct statutory principles as set out in section 160 of the Inheritance Tax Act (IHTA) 1984; it states: "the price for which the property might reasonably be expected to fetch if sold in the open market". These valuation rules apply to death and lifetime gifts. The valuation of any house of reasonable value is likely to be queried by the district valuer (DV)."

Deed of variation

If the taxpayer's will does not take advantage of the NRB, then the deed of variation can be put into place by the beneficiaries.

Changes to the distribution of property under the will or intestacy of the deceased can be made by agreement of the beneficiaries and the changed asset distributions treated under section 142 of the IHTA 1984, as if affected by the deceased.

A disclaimer or variation must be in writing and made within two years of the death. It must not be made for any consideration to money or money's worth (except the mak-

ing, in respect of another of the deceased's dispositions, of another disclaimer or variation treated as made by the deceased).

Under a deed of variation, all persons who would benefit from the dispositions (or do so as a result of the deed) must be a party to the deed. Under a disclaimer, all concerned must consent.

For deeds of variation, two separate time limits must be satisfied:

- the deed of variation must be effected within two years of the date of death; and
- within six months after the date of the deed, a formal election must be made, signed by the persons making the variations.

How the property is held by husband and wife or civil partners

To examine the tax mitigation of the family home, one must look at ways the property can be held by husband and wife or civil partnerships as follows:

- Joint tenants – the survivor takes the entire interest absolutely and by operation of law. It is, therefore, impossible to make lifetime dispositions to third parties because this interest accrues automatically to the survivor, which will be restrictive to IHT planning.
- Tenants in common – usually the most efficient from the IHT and practical viewpoints, each spouse or civil partnership has a separate share, of which he or she can bequeath and dispose separately.

Parents gifting the home to their children

Many parents contemplate gifting their home to their children. However, unless it involves a market rent, it becomes a gift with reservation of benefit (GWRB).

So, the parents gift their home to their children and pay market rent for continuing to live there. What problems emerge? If the parents pay the rent out of after-tax income, and the children pay income tax thereon, it does not provide the means to get further funds out of the parents' estates. However, the children lose the Capital Gains Tax (CGT) private residence exemption while their parents occupy the house. Therefore, the children could pay high CGT when they sell.

In any situation of gifting to the children (or indeed any other members of the extended family) one should severely observe the rules relating to GWRBs or pre-owned assets (POATs).

GWRBs

If, while still occupying the house, the parents gift it to the children, the gift can be counted to the taxpayer's estate as

chargeable to IHT via the GWRB rules. In practical terms, the gift is brought back into the deceased's estate, as though it had never been gifted.

POATs

The gift to the children of the house should be subject to an income tax charge if the parents still enjoy visits or stays. The interaction of POATs and GWRBs must be taken into consideration.

Moving to a smaller property

This simple solution may well be attractive, with the capital released then being gifted. The parents may prefer to move to a smaller property in retirement. The monies released can then be spent on enjoyment with a possible 40 per cent advantage or put aside for such matters as future care costs.

Development potential of the home

The parents' home could have development potential, such as scope for a house built in the garden. Provided the garden fits the principle private residence (PPR) considerations (half a hectare, including the house), then this could be developed and sold "tax-free" to realise cash passed down to the next generation, as a lifetime gift or to be used for care costs. The development of the garden can be a tax-efficient method of realising money from the house.

However, if the parents are elderly, and the development proceeds are potentially high, then consideration could be given to delaying the planning permission so that the children appreciate the uplift in value. Likewise, the lifetime gift of the garden could be quite tax-efficient, as it should escape CGT by the parents under the PPR rules and, provided the parents live seven years, should escape IHT. The use of a property consultant to assess not only the value of the home, but also the potential of the home must not be overlooked.

Borrowing on the property

Secured borrowings reduce the value of the property for IHT purposes, irrespective of the use made of funds borrowed. For example, they could be invested in shares in an Alternative Investment Market (AIM)-quoted trading company, with the result that 100 per cent business process re-engineering (BPR) becomes available after two years.

One of the alternatives that the children may dislike involves the parents borrowing money on the home to enjoy a better lifestyle or if pensions are insufficient for survival. Equity release schemes can be obtained through the protection of the financial services industry, whereby the owner can borrow with capital repaid on death. Many alternative >>

<< schemes exist, as well. However, there are rules that restrict the percentage of borrowings based on age in an attempt to protect the homeowner taking the loan. Caution must obviously be exercised, and, possibly, a number of financial services consultants contacted to ensure purchase of the best product.

Furnished holiday lets (FHLs)

Family homes might actually be homes in which IHT protection is also needed for the second property. If this property is a holiday property, then the FHLs tax relief can come in to play, provided the property meets the requirements and is actually let to holidaymakers. The tax relief includes potential for 100 per cent IHT relief.

IOU on death

The question of IOU has been promoted extensively as an IHT planning tool, but can it really be used without HMRC taking undue interest? An arrangement accepted by HMRC in principle, but they may look at the NRB trust to argue the sham, or the surviving spouse, has an interest in position. So what does it involve?

IOU on death involves a NRB gift in the will of the first spouse to die, by way of an IOU from the surviving spouse, in return for which he or she receives an increased share in the house. Alternatively, a charge is imposed over that share by the personal representatives. Practitioners should:

- ensure accuracy of the documentation, including a proper loan agreement following the death;
- have annual trustee meetings where the arrangements are reviewed and discussions recorded; and
- when involving interest, ensure it is rolled up, creating an income tax liability on actual receipt only; that is, after the surviving spouse's death, and there is then an IHT deduction in the estate.

The investment risk must be given due consideration, a suggestion only feasible when the homeowner has some link, commitment or firm desire to invest in the company.

If interest is not charged, it should be one of the points discussed at the annual meeting. The surviving spouse is, of course, a beneficiary, and there would not appear to be any necessity to charge interest.

Lease carve-out

The 1999 anti-avoidance legislation to stop the Ingram scheme should not apply if the parent owned the interest in the property for at least seven years and, accordingly, continues to occupy the property as a result of that pre-existing right. The interest owned is, of course, the lease granted, say, to himself and his spouse for a specified number of years, which will exceed the survivor's expectancy of life.

After seven years, the freehold reversion can be gifted as a potentially exempt transfer (PET) under existing legislation,

but this timeframe will not be regarded acceptable by some clients.

The costs incurred in sorting the original lease carve-outs (in addition to the scheme's huge costs) has been such a nightmare for many taxpayers that many practitioners and clients appear quite nervous about approaching the arrangement. Advisers, check your professional indemnity insurance!

The cost of potential care for the elderly and the tax consequences

All arrangements concerning IHT mitigation and the family home must consider the potential cost of care for the elderly.

A reality that cannot be ignored when calculating future IHT liabilities, it has been said that the most effective IHT mitigation policy spends the wealth in care costs.

If care is in a residential nursing home, there is scope to sell or let the house to provide finance for these fees when

not funded out of income. One must give consideration to the potential loss of principal private residence relief for the homeowner if her or she exceeds 36 months of non-residence as a result of being in the nursing home. When studying all IHT mitigation, one must essentially calculate the future cost of care, in addition to the legal and tax consequences of the homeowner no longer residing in the house, and the possibility of forced sale due to the need to pay for care costs.

Associated operations rule

The legislation defined in section 268 of the IHTA 1984, dealing with associ-

ated operation rules and care, must be considered to justify that no mitigation plans become caught under these rules.

The way forward

All the alternative considerations for IHT mitigation on the home emphasise the need for input by professionals and the clear involvement and advice of family members. The requirement for accurate property valuations, with a need for the consideration of the market rent for the property and future development potential, is integral to planning. Tax planning must incorporate will drafting and legal documents to support all arrangements, such as the lease of the property, and forecasts for potential costs of care cannot be ignored.

In addition, the Chancellor might change the IHT legislation at any time. Look out for the snakes and the ladders that could be difficult to climb.

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