Woe, thrice woe!

MALCOLM GUNN tries to solve the inheritance tax problems involved with holding business premises outside a trading company.

It was the soothsayer Senna in *Up Pompeii!* who gave the warning of woes to come for its citizens as with the ancient city of Gomorrah, adding after a pause, 'and Sodom!' I thought I might borrow her pronouncement to cheer the holiday season along. My woes are for those who own trading premises used by a family company.

The scenario

With such companies it is quite common for the business premises to be held by one or two of the shareholders. Perhaps this is to give the property some protection from claims of creditors and the like if the business fails. Alternatively, this may be recommended because it can be fairly easy to claim entrepreneurs' relief on the sale of the property as an associated disposal. If the gain is in the company there can be two layers of tax, once in the company and second on the shares.

This holding structure does, however, bring about a significant inheritance tax problem which is that the premises either have no entitlement to inheritance tax business property relief or, at best, earn only 50% relief.

The 50% relief applies to 'any land or building ... which, immediately before the transfer, was used wholly or mainly for the purposes of a business carried on by a company of which the transferor then had control...' (See IHTA 1984, s 104(1)(b) and s 105(1)(d).)

The property owners will not, in any circumstances, be entitled to 100% relief for the building because this applies only where the premises are part of business itself. (See IHTA 1984, s 104(1)(a) and s 105(1)(a).)

So you can see how the woes are beginning already.

KEY POINTS

- Consider whether the extent of the owner's control of the business in terms of shareholdings.
- Factory could be given to the children as a potentially exempt transfer.
- Selling the premises to the company may give rise to other issues, such as stamp duty land tax.
- Impact of the First-tier Tribunal decision in *Reeves* on holdover relief and non-UK residents.

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Eruption imminent!

Let's assume that fellow cast member of Senna, Ludicrus, who is in his 80s, holds the factory used by the family company, M Vesuvius Ltd. The company makes fireworks. Originally, Ludicrus held all the shares but later he gave some to his wife for tax planning purposes –readers with long enough memories will recall that she delights in the name of Ammonia. Over the years they have both passed down some shares to the younger members of the family, including son Nausius and daughter Erotica (those days were less politically correct).

Ludicrus has now discovered the inheritance problem with the factory and is somewhat shocked that, although his shares can pass to his children free of inheritance, the factory will not. On his death, the inheritance tax can be paid in ten annual instalments which is some consolation, but interest will be added from the word go – interest relief (calculated only from the due date of each instalment) is given for a property qualifying for agricultural relief but not a fireworks factory. If the premises are sold after his death and new premises bought, all the tax then falls due for payment. Apparently, HMRC's inheritance tax policy people do not talk to those dealing with capital gains tax rollover.

Only control freaks need apply

The first step to solving the inheritance tax problem will be to look at whether Ludicrus has control of the business because this is the primary requirement for 50% business property relief on the factory.

For this purpose any shares held by Ammonia can be counted in (IHTA 1984, s 269(2)) so if the two of them still together have a controlling shareholding, it will not matter that only one holds the premises. Inheritance tax relief at 50% would then be available for the factory. It is likely that Ludicrus will leave the premises to Ammonia in his will to have the benefit of the spouse exemption at that stage. Then the control issue will be more important as regards the estate of Ammonia.

Two-year test

It may not be so simple as this. Perhaps they have already passed more than 50% of the shares to younger members of the family or to family trusts. In that case it would be sensible so consider whether they should reacquire control of the company. If this can easily be done by persuading Erotica or Nausius to give back enough shares, that will be satisfactory for inheritance tax purposes so long as the gift back is not consideration for any other transaction. It might be thought that the control holding must then be held for two years before the 50% relief becomes available on the factory. In fact this is not so. The rule is in IHTA 1984, s 105:

> 'Land, building, machinery or plant owned by the transferor and used wholly or mainly for the purposes of a business carried on as mentioned in sub section (1)(d) or (e) above is not relevant business property ... unless shares or securities of the company carrying on the business immediately before the transfer are relevant business property in relation to the transfer.'

So then it is required only that Ludicrus has some shares that qualify for business property relief at the time of the transfer. It is not required that the full control holding is held for the two-year period.

Lifetime gift

Assuming Ludicrus and Ammonia do have control, Ludicrus might then take the simple step of just giving the factory to their children Erotica and Nausius. The seven-year survivorship period for lifetime gifts will apply and any capital gain can be held over, assuming all of the premises have been used in the business. Job done, one might think, but alas this is where my first set of three woes introduces itself.

A lifetime gift is capable of making the tax position much worse. The first woe is that the tax-free uplift in the capital gains base cost on death is forgone. The second woe is that for the seven-year period the inheritance tax liability does not go away. It will taper after three years of survivorship from the date of the gift, but for three years there is the full inheritance tax risk.

And there is the third woe. A common fallacy is to proceed with a lifetime gift on the basis that, so long as it is made by a controlling shareholder, at least the 50% relief is 'banked' so for the seven-year period the main drawback is the loss of capital gains tax uplift on death. Unfortunately, the inheritance tax rule relating to lifetime gifts of business property does not operate in this way.

Should Ludicrus die within seven years from the date of the gift, IHTA 1984, s 113A requires that the position of the transferees as regards control of M Vesuvius Ltd must be tested separately either at the death of Ludicrus or, if the transferees have already died, on the death of each of them. So on whichever of those events applies, each transferee also has to be a controlling shareholder if Ludicrus's 50% relief is to be preserved throughout the seven-year period. It will not be possible to organise this, because there are two transferees who are not spouses.

For the first three years after the gift, therefore, Ludicrus will be exposed to full inheritance tax liability on his demise, without even 50% relief and, after that, the tapering of tax liability on lifetime gifts will start to improve the position. Even if the property is given to one child alone, the relief requires that the transferee also becomes a controlling shareholder.

If it is decided to go ahead with the gift, it would be wise to take out some life insurance cover for at least a three-year period.

> ***"Due to a strange quirk, the position can be better if the gift is into a trust for the next generation."***

Gift into trust

Due to a strange quirk, the position can be better if the gift is into a trust for the next generation instead of outright to them. In such case the relief itself is still at risk for seven years after the gift but, if it is withdrawn on the death of the settlor, the settlor's cumulative total brought forward remains unchanged at the value after deducting relief. This is because IHTA 1984, s 113A(2) just requires the tax calculation on the chargeable transfer to be reworked disallowing the relief but it does not require the cumulative total to be changed.

This will not help Ludicrus much with his valuable factory premises because there might be a lot of inheritance tax to pay with the trust route. It does mean that in other cases there is no risk if the chargeable transfer into trust is in the nil band – for example land worth £325,000. There will then be no tax on the transfer and, if relief is withdrawn, the cumulative total carried forward remains unchanged at £162,500. For a transfer of an asset worth £650,000, there is no immediate tax, and the cumulative total is £325,000. If the relief is withdrawn on death, tax will become due on £325,000 for the transfer into trust, but the cumulative total is unchanged. In such a case it might have been better to keep the asset until death and collect the 50% relief then plus the tax-free uplift in base cost.

“Transferring the premises to the company is likely to be fraught with problems and a further three woes are looming.”

Transfer premises to the company

In theory, the inheritance tax position will be solved if the premises are given to M Vesuvius Ltd. The value of the premises is then reflected in the shares and, as long as the shares have been held for a two-year period, 100% business property relief will be available on them because this is a manufacturing business. However, transferring the premises to the company is likely to be fraught with problems and a further three woes are looming.

First, there is a stamp duty land tax liability whether the premises are gifted or sold.

If the premises are given to the company, it might be supposed that this will be a potentially exempt transfer (PET) for inheritance tax purposes to the extent that the other shareholders benefit. After all, the value of their shares increases and the PET provisions allow for gifts by virtue of which the estate of another individual is increased.

Unfortunately, this paraphrases the PET provision rather too much. If the gift increases the estate of another individual but is not a gift made directly to that individual, it is required that the value transferred is not attributable to property which becomes comprised in the estate of another person. With the gift to a company, the premises become comprised in the estate of the company, and so the gift cannot be a potentially exempt transfer. The result is that the gift is a chargeable transfer so there will be an immediate inheritance tax liability after the 50% relief.

A Ludicrus decision?

In some cases the tax problems will not end there, and so here comes my third woe under this heading. The somewhat extraordinary (some might say bonkers) decision of the First-tier Tribunal in *Reeves* (TC5680) held that TCGA 1992, s 167 can interfere with the capital gains tax holdover to the company even if all the shareholders are UK resident.

Section 167 denies holdover if the transfer is to a ‘foreign controlled company’, this being one that is controlled by any persons who are non-UK resident and who are connected (in capital gains tax terms) with the person making the transfer. This is not as straightforward as it seems.

The control test refers across to provisions in the close company legislation by which share rights can be attributed to associates. As a result, the tribunal held that if any associate can be found who is non-UK resident, whether or not they have any shares in the company or even know about its existence, the holdover can be denied because the company can be treated as foreign-controlled.

As counsel for the taxpayers pointed out, this means that, if there is a grandson of the person who is making the gift to the company and the grandson is non-resident, say working in Africa for a few years, then, even though the grandson has no interest in the company and has nothing to do with it, the company is treated as foreign controlled. Then, there can be no holdover relief.

Readers might wonder whether this was a decision by the cast in *Up Pompeii!* but in fact it was the First-tier Tribunal that reached this conclusion even though TCGA 1992, s 288 applies the close company control test ‘unless the context otherwise requires’. Perhaps this will go further on appeal. I hope so because it is relevant to a case I have been looking at recently.

Any other ideas?

Hypothetically, the inheritance tax position could be managed by giving away a reversionary lease over the factory. So long as the freehold has been owned for at least seven years, the reservation of benefit provisions of FA 1986, s 102A will not apply, and possibly they never apply anyway to land not occupied by the donor – HMRC seems to suggest this in the *Inheritance Tax Manual* at IHTM14360. Equally, pre-owned assets charges will not apply. But I doubt that this would be a practical solution.

For a start, reversionary lease arrangements need quite a bit of time to run through to achieve the desired results and they suffer from the big disadvantage that the donee’s capital gains tax base cost will be small compared with the actual base cost in the premises. That stores up a capital gains tax problem for the future and there is still the main inheritance tax risk if the donor does not survive the gift for many years. That is a couple of woes at least.

Which way forward?

Evidently the best solution is to start the inheritance tax planning as early as possible, unless the property owner is a controlling shareholder and is willing to give the controlling interest away with the property. Failing that, it does seem that it will be a question of how many woes the holder of the business premises can put up with.

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