EFFECTS OF THE NEW IHT PROVISIONS IN FINANCE BILL 2013

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Effects of the new IHT provisions in Finance Bill 2013

Produced by Tolley

This article looks at some of the practical effects of the new IHT provisions in Finance Bill 2013:

- an increase in spouse exemption for transfers to non-UK domiciled spouses and civil partners
- the ability to elect to be treated as domiciled in the United Kingdom
- restrictions on the deduction of liabilities for IHT

Throughout this article, references to spouses include civil partners; the term 'partner' means both a member of a married couple and a registered civil partnership.

Increase in spouse exemption

The lifetime exemption for transfers from UK domiciled spouses and civil partners to their non-UK domiciled partners has been capped at £55,000 since 1983. Responding to criticism from the European Commission that the low threshold was discriminatory, Finance Bill 2013 introduces a welcome increase in the limit. With effect from 6 April 2013, it is increased to £325,000 and will thereafter match the level of the nil rate band. As a result, a UK domiciled spouse will be able to transfer twice the value of the nil rate band to his non-UK domiciled partner before incurring a tax liability.

IHTA 1984 s18 (2)

Remember, though, that the non-domiciled spouse exemption is a lifetime limit, whereas the nil rate band is refreshed every seven years. For lifetime gifts that exceed the spouse exemption, the balance is initially a potentially exempt transfer (PET) which only becomes chargeable if the donor dies within seven years. Example 1 illustrates how this works in practice.

For gifts made before 6 April 2013, the old limit of £55,000 still applies and can remain relevant for deaths and transfers after 6 April 2013. A gift in 2012 of £200,000 will have been £55,000 spouse exempt and £145,000 PET. If the donor dies in 2014, the PET is taken into account in the death estate even though the value of the 2012 gift was within the new level of spouse exemption. The additional exemption will be set against the death estate and not the gift. This could affect how the burden of inheritance tax is distributed where there are other beneficiaries of the estate.

In many smaller estates, the new limit will be sufficient to transfer the UK domiciled partner's estate without using the nil rate band. The unused NRB can be transferred to the non-UK domiciled partner in the usual way. See Example 2.

Election for UK domicile

Another new provision relating to non-UK domiciled spouses and civil partners is the election to be treated as UK domiciled. The obvious advantage in making such an election is that the exemption for transfers from the UK domiciled spouse or civil partner becomes unlimited. The non-UK domiciled partner will be entitled to inherit the whole of their partner's estate tax free. The disadvantage is that the election causes the non-UK domiciled partner to be fully taxable on their worldwide assets, instead of just their UK assets.

IHTA 1984 draft s 267ZA and s 267ZB

So whether to make the election or not will depend very much on individual circumstances - not just the value and location of each partner's assets but the long term plans of the couple and the tax regime of the jurisdiction in which the non-UK domiciled partner is domiciled. Double taxation relief will be available in the usual way.

If the couple live permanently in the UK and the non-domiciled partner has few assets located abroad, the issue appears to be simple: the election should be made to enjoy the unlimited spouse exemption. Bear in mind though, that the election is irrevocable whilst the non-domiciled partner remains resident in the UK. What if, at some point in the future, he inherits valuable assets from relatives abroad? Quite possibly, his mother's house in Australia could be brought into the UK inheritance tax net. This is a particularly bad idea if the domicile jurisdiction does not levy its own version of inheritance tax.

Fortunately, the decision as to whether to make the election can be deferred until after the death of the UK domiciled spouse. The election can also be backdated for seven years, so it is not necessary to predict the future to make an efficient arrangement.

The options regarding the timing of elections can be categorised as follows:

Lifetime election - A non-UK domiciled person whose spouse or civil partner is alive and domiciled in the UK can elect to be treated as UK domiciled at any time after 6 April 2013.

Death election - A non-UK domiciled person whose UK domiciled spouse or civil partner has died on or after 6 April 2013 can elect to be treated as UK domiciled within two years of the partner's death.

Death election by personal representatives - This is an extension to the death election. Where a non-UK domiciled person has died, his personal representatives (PRs) may make a death election on his behalf. The conditions for the death election are otherwise the same.

Note that the terms 'lifetime election' and 'death election' refer to whether the UK domiciled partner is alive or dead, not the partner making the election.

In every case, the election can be backdated up to seven years, provided the couple were married or in civil partnership throughout that period, but the effective date can be no earlier than 6 April 2013. The election is irrevocable but it will cease to have effect if the electing partner becomes not resident in the UK for a period of four successive tax years after making it. The election is to be made in writing to HMRC but there is no prescribed form.

In considering whether a person is or was UK domiciled or not, the deemed domicile provisions under IHTA 1984, s 267 are ignored. The election does not affect the non-domiciled partner's income tax or capital gains tax status for the purposes of the remittance basis rules set out in ITA 2007, s 809B and the following sections, nor does it affect his domicile status under general law.

When should the election be made?

A death election by a non-UK domiciled person is the most useful option. Indeed, the circumstances in which a lifetime election could be useful are somewhat remote, since gifts between individuals qualify as PETs to the extent that they are not exempt. (And lifetime gifts into trust for the benefit of the spouse do not qualify for the spouse exemption.) It is usually better to wait and see. Consider the scenario outlined in Example 3.

If it turns out that the non-domiciled partner dies first without having made a lifetime election, the opportunity of making any election is lost. The option for the non-domiciled partner's personal representatives to make an election applies only to a death election, of which the essential feature is that the UK domiciled partner has died first. However, the loss of the lifetime election option is of little consequence when the non-domiciled partner dies first because transfers **to** the UK domiciled partner are fully exempt.

In certain, somewhat unusual circumstances, the lack of a lifetime election could increase the total tax bill where the non-domiciled partner dies first and the estate passes to other beneficiaries. Gifts he has received from the UK domiciled partner can become chargeable in the partner's estate if he dies shortly afterwards, whereas, if a lifetime election had been made, they would have been exempt. See Example 4.

A death election by the non-domiciled spouse's PRs would only be possible in circumstances where the UK domiciled partner has died first, and the death of the non-domiciled partner occurs within two years of the first death. The PR's will have the opportunity of making an election to reduce the total tax charge on the combined estates.

Deductions for liabilities

Finance Bill 2013 has introduced anti-avoidance provisions on the deduction of liabilities aimed at some esoteric tax saving arrangements. Coincidentally, or perhaps intentionally, the new rules also have a wide application to a more basic type of tax planning, which all business advisers should be aware of. See Business loans below.

The new measures concern the basic rule that inheritance tax is charged on the net value of an estate after deduction of liabilities.

IHTA1984, s 5(3)

This rule has been modified by the requirement that a liability must be deducted from the asset on which it is secured. So if a mortgage is secured on a house, the net value of the house is included in the valuation of the estate. The requirement can affect the total tax liability on an estate where, for example, an asset reduced by a secured loan passes to an exempt beneficiary. The chargeable portion of the estate is not reduced by the liability.

IHTA1984, s162

The rule may be disadvantageous in certain circumstances but it can also been used to the taxpayer's advantage. It has led to arrangements where the value of chargeable assets is reduced by loans used to purchase non-chargeable assets.

Finance Bill 2013 introduces three new provisions on the treatment of liabilities. The rules are somewhat convoluted but, essentially,

- where a liability is attributable to financing the acquisition or maintenance of excluded property, it is to be matched with that property
- where a liability is attributable to financing the acquisition or maintenance of property which qualifies for Business Property Relief, Agricultural Property Relief, or Woodlands Relief, it is to be matched with that property
- a liability may reduce the value of a person's estate on death only if it is paid out of the estate in money or money's worth

IHTA1984 draft s162A, s162B, and s175A

The effect of the first two provisions is to ensure that loans financing the purchase of exempt or relieved property are deducted from the value of the assets qualifying for relief, which means, of course, that no tax will be saved because the assets are already relieved.

The third new provision refines the general rule that the amount of any deduction is normally the value of liabilities as at the date of death. It is aimed at arrangements where a deduction in a death estate is claimed, but in the event the liability is never paid. It excludes genuine commercial reasons for not paying the debt.

Avoidance schemes

Some of the tax arrangements affected by these new measures include:

- **Schemes involving AIM listed investments.**

  Some financial advisers promote IHT 'solutions' involving the acquisition of a portfolio of shares that qualify for BPR after two years. The investment is financed by securing a loan on the home or other chargeable assets. Under the new rules, the value of the chargeable assets will not be reduced.

- **Transferring value offshore**

  A non-UK domiciled person may obtain a loan secured on UK assets and invest the cash overseas, thereby reducing exposure to inheritance tax on the UK property. The new provisions will attach the loan to the excluded property.

- **De-enveloping**

  The new taxes on high value residential property held by companies are encouraging the extraction of UK property from the corporate envelope. The property then becomes subject to UK inheritance tax, but arrangements have been devised to make 'de-enveloping' more attractive by reducing the value of the property with a debt secured against it. The proposals on liabilities mean that arrangements that transfer the value of the loan to excluded or relieved property will be ineffective.

- **Loans from employee benefit trusts**

  The disguised remuneration provisions prevent the creation of notional loans to remunerate employees. Nevertheless, loans which pre-date those provisions may remain outstanding. In most cases, it is not intended that the loan will be repaid but if it is written off it will be subject to an income tax charge. The new IHT provision for the discharge of liabilities after death will prevent an outstanding loan from reducing the death estate if it is not repaid.

Business loans

Aside from artificial schemes, the new measures will affect ordinary UK businesses. It is common for business owners to obtain finance for their enterprise by mortgaging their home, since it may be the only asset deemed suitable as a security. The arrangement includes an inheritance tax advantage because of the requirement that an incumbrance on a property reduces the value of that property. So when the business owner dies, the business qualifies for BPR and, in addition, the chargeable value of the home is reduced by the mortgage.

The proposals in Finance Bill 2013 will require that the liability is detached from the home and re-attached to the business if it qualifies for BPR.

Commentators have questioned whether this was the real intention of the Chancellor. It is indeed a shock for business owners who will have assumed that the liabilities secured on their personal assets would reduce their exposure to inheritance tax. Whether intended or not, it is unlikely that the government will concede any exceptions on this point. The measure may have been unexpected but, objectively, it is difficult to see how it is unfair. Whilst the business owner's family will have to finance the tax on the home, and may even have to sell the home to do so, that dilemma is often presented to families faced with an inheritance tax bill: personal property, including the home, has to be sold to pay the tax.

In many cases, the purpose of charging a business loan on personal property was not to save inheritance tax. Offering the home as security may be the only way a business can obtain finance, in which case the arrangements will have to stand. However, if a business owner has a choice on whether to accept a charge on his home or a charge on business assets, he may now prefer not to put his home at risk since it offers no tax advantage.

Obtaining finance for a relievable business may be tied up with the owner's other personal and commercial interests and it will not always be clear which asset a loan is financing. The taxpayer will need to be able to demonstrate that a particular liability should be attached to the chargeable assets where there are other assets eligible for BPR and APR in the estate. Documentation and bank statements illustrating the sequence of events should be retained. Remember that the acquisition of property and the loan to finance it may have been instigated long before the chargeable occasion.

So, for the business owner, care should be taken to match liabilities with the non-business assets they finance and retain the evidence. Interestingly, the provision does not work in reverse, as illustrated by Example 5.

Tax planning now rendered ineffective by the new provisions may have taken place many years ago. Practitioners should review past arrangements in the light of the proposed changes so that they can warn clients of any additional exposure to IHT.