Deal with liabilities before death

Dominic Ribet reports on whether the amendments to IHT legislation contained in the recent Budget will lead to any unintended consequences

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The 2013 spring Budget saw George Osborne take aim at hitherto uncontroversial arrangements that used liabilities (debts) to reduce the value of an estate.

Draft legislation contained in Schedule 34 of the Finance Bill 2013, issued shortly after the Budget, provided more detail on the revised regime and the amended inheritance tax (IHT) legislative framework that will soon come into force. The changes will affect chargeable transfers occurring after the Finance Bill receives royal assent later this summer. The sum total of the changes is that the new provisions will act to limit the circumstances where the deduction of liabilities will be allowed for the purposes of calculating the charge to IHT. The changes will also indirectly limit the usefulness of agricultural property relief (APR) and business property relief (BPR). These reliefs can be generous and their continued existence suggests that the government wants to continue to encourage business owners to set-up, develop and pass on businesses to the next generation, rather than force their break-up on the death of the founder to meet the resultant IHT liability. Similarly, no one can contest the economic logic of ensuring that a family farm remains of an appropriate scale required for a viable farming operation (rather than being gradually broken up as they are passed down generations to meet IHT bills caused by a farmer's death). HMRC has, however, been keeping a close eye on the use of these reliefs and persistent rumours have emanated from both government circles and among practitioners about the possibility of either their total withdrawal or the introduction of more stringent limits on the use of APR and BPR. It would seem that the unheralded change in the deduction of liabilities contained in the Finance Bill (upon which there was no consultation) is the HMRC's indirect method of controlling and limiting what they see as unreasonable abuse of these reliefs. The resulting economic impact of these changes could, however, be far greater than the HMRC has anticipated.

Valuing an estate

The starting point when valuing an individual's estate for IHT purposes is to value both the assets and liabilities that existed at the date of death. In most circumstances, executors have been able to deduct the value of certain liabilities from the gross value of an estate, so long as these liabilities have been incurred by the deceased before the date of death either:

- for a consideration in 'money or money's worth'; or
- if the liabilities were imposed by operation of law (s5(3) Inheritance Tax Act 1984 'IHTA'). Until now this deduction has been allowed for the full value of the liabilities due to a creditor and not for the amount actually repaid to them. In practice this has meant that substantial liabilities, such as mortgages charged against the

family home, have been deducted (on evidence being supplied of the mortgage) from the value of that property when preparing the necessary IHT return.

HMRC claimed that general misuse of these deductions led them to introduce additional legislation (in Finance Act 1986), which meant that the deduction of artificially created debts would, from that point on, no longer be permitted. Genuine commercial loans on residential properties have however continued to be made, both to raise monies to purchase properties (for most people!) but also as a basic tax planning device for practitioners looking for permitted methods to suppress the IHT value of wealthy client's residential property. Some clients have also been making rather more adventurous (but legitimate) use of this deduction by using the loan proceeds to purchase assets that would not (on death) be subject to the charge against IHT if certain conditions could be satisfied.

These types of assets could be:

- Excluded property – there are certain types of property (detailed in s6 IHTA) that are excluded from the charge to IHT including (but not limited to) property situated outside the UK (where the beneficial owner is not domiciled in the UK) or UK government bonds (also known as 'gilts') (where the beneficial owner is neither domiciled nor resident in the UK).

- Agricultural property (to benefit from APR under s116 IHTA) – where certain conditions regarding the duration of ownership and the manner of occupation are satisfied, IHT relief at a rate of either 50% or 100% of the agricultural value of the property can be claimed when a chargeable event occurs.

- Business property (to benefit from BPR under s104 IHTA) – if certain conditions are met BPR can be claimed on the transfer of 'relevant business property' that has been held for at least two years. The business must be a qualifying business in that it is 'wholly or mainly' a trading entity (as opposed to a business that only holds investments). Case law has developed and interpreted the phrase 'wholly or mainly' so that a qualifying business is one that, when looked at objectively (and with reference to the relative capital value of trading and investment assets, turnover, profit, management time and labour), is mainly (over 50%) engaged in a trading activity rather than an investment activity. Where BPR applies, the whole value of the business would, depending on the type of asset, qualify for BPR at a rate of either 100% or 50%.

- Woodlands (to benefit from woodlands relief under s125 IHTA) – this relief is only available on death and operates to defer an IHT charge. The executors of a deceased's estate that own woodland can ask that the value of the timber (but not the land) is excluded from the estate until the timber is sold. The IHT becomes due on the value of the sale unless it also qualifies for relief. The woodland may also qualify for APR, in which case woodlands relief may not be available. Business relief may also be available on woodland that qualifies as a business asset.

Woodlands, agricultural and business property can all potentially benefit from the reliefs described above and can collectively be referred to as 'relievable property'.

It is difficult to estimate the number of assets that have been purchased specifically for the reason of the beneficial IHT treatment mentioned above. HMRC will certainly have been able to gather information on the number of claims for the use of these reliefs and they will also have been aware of the increasing number of purchases of agricultural property for significant sums of money. Indeed, it is estimated that over the last fiveyears, prices in England have increased by over 20% for all farmland and over 60% for farmland without any buildings on it (what is known as 'bare land'). It may be that HMRC has concluded that these significant price increases are evidence of an increasingly widespread practice of people trying to mitigate their IHT exposure by purchasing scarce farmland. Similarly, HMRC will have been aware of the active promotion of IHT saving BPR property investments, such as AIM shares, and other assets that can potentially benefit from BPR sold by independent financial advisers and others. In any event, HMRC's own estimate of the impact of the changes will be that it raises just £70m over the next five years.

No one can contest the economic logic of ensuring a family farm remains of an appropriate scale required for a viable farming operation (rather than being gradually broken up as they are passed down generations following a farmer's death).

The changes

Deductibility of liabilities on death

Section 175A IHTA has been introduced by Finance Bill 2013 to restrict the use of liabilities outstanding at the date of death to reduce the overall value of an individual's estate for the purposes of IHT. The new rules mean that liabilities that would otherwise be allowed as a deduction from the value of an estate can now only be used to reduce that value if they are actually repaid out of the estate on or after death. If liabilities are not going to be repaid on death, they can only be deducted (and therefore reduce the value of the estate) if there is a real commercial reason for the liability remaining outstanding. Section 175A(3) IHTA confirms that a 'real commercial reason' would be present if the liability was to a person

dealing at 'arms length' and that the creditor does not require that the liability be repaid) and that the liability is not being left outstanding to secure a 'tax advantage'. 'Tax advantage' is defined in s175A(4) IHTA as any situation where a liability would be left outstanding to secure (or increase the rate of) a relief from tax or repayment of tax, or avoid, reduce or delay the payment or assessment of tax. This broad definition encapsulates income tax and capital gains tax as well as IHT. Finally, there must also be nothing else in IHTA 1984 that would prevent the liability from being used to reduce the value of the estate for IHT purposes.

HMRC has also introduced new provisions relating to the treatment of outstanding liabilities which can be used to reduce the value of an individual's estate as at the date of death (s175A(6) IHTA). These are deeming rules that are designed to remove any ability to circumvent the restrictions by carefully timing the repayment of these liabilities.

Ultimately, if there is any question that these provisions will apply, clients should be advised that they will need to make the necessary financial provision so that the liability is actually repaid on death to avoid any questions being raised as to whether it is deductible from the value of the estate on death.

Many businessmen who have risked the security of their home to invest in their business could find that their IHT exposure could markedly increase as a result of the changes detailed in Finance Bill 2013.

Excluded property

Section 162A IHTA has been introduced to restrict the use of liabilities being used to reduce the chargeable value of an asset for IHT purposes where the liability can be attributed (directly or indirectly) to financing the acquisition, maintenance or enhancement of excluded property. If the excluded property has been sold for full consideration for 'money or money's worth' the liability may still be taken into account as long as the consideration itself was not excluded property and the consideration has not been used (either directly or indirectly) to:

- finance the acquisition, maintenance or enhancement of excluded property or;
- to discharge any other liability that would not be taken into account under s162A. The deduction of the liability may also be denied even where the value of the liability is greater than the excluded property if the reason for the liability being of greater value is because:

- the greater value has been manufactured by some form of arrangement of which one of the main proposes was to secure a tax advantage (deemed under s162A(4) to be the avoidance or reduction of a charge to tax or the avoidance of a possible determination in respect of tax);
- the greater value can be attributed to interest being added to the liability or by the liability being increased by some other method; or
- the greater value is caused by the sale of the excluded property.

Example 1

A non-UK domiciled taxpayer's sole UK asset is a flat worth £500,000. He also owns a Swiss apartment worth £100,000. Under the old rules he could reduce his UK IHT liability to zero if he were to borrow £500,000 from a UK bank secured on the UK property (which would reduce its probate value to zero) to carry out repairs and renovations to the Swiss property. However, under the new rules, if the repairs and renovations lead to the Swiss property being worth £750,000 the liability cannot be set against the value of his UK IHT estate because the value of the £500,000 loan would not be greater than the value of the excluded property (£750,000).

As above, if there is any danger that these provisions will apply, clients should be advised that they will need to make the necessary financial provision so that the liability will actually be repaid on death to avoid any questions being raised as to whether it is deductible from the value of the estate as at the date of death.

Relievable property

Section 162B IHTA introduces similar restrictions to those affecting excluded property to limit the extent to which liabilities that (directly or indirectly) finance the acquisition, maintenance or enhancement of relevant business property can be used to reduce the IHT value of the deceased's estate. The restriction works by reducing the value of the relevant business property that has been financed by the liability before the relief of either 100% or 50% (mentioned above) is applied.

Section 162B(3) uses the same method to restrict the deductibility of liabilities used to finance the acquisition, maintenance or enhancement of agricultural property that might benefit from APR. The restriction reduces the value of agricultural property that has been financed by debt by the amount of the liability before the relief of 100% or 50% is applied under s116 IHTA.

Section 162B applies similar restrictions to liabilities that fund the purchase of woodland that benefits from woodlands relief (mentioned above) by reducing the value of the woodland by the amount of the associated liability before the relief is applied.

Section 162B(5) extends the limitation on the deductibility of liabilities used to acquire, maintain or enhance either relevant business

property or agricultural property to 'relevant property trusts' but not liabilities used to acquire, maintain or enhance woodland. Practitioners will therefore need to consider carefully the implications of these changes in anticipation of a ten-yearly charge on such a trust.

HMRC have also introduced new rules to govern the order in which liabilities will be deemed to have been repaid (s162C IHTA) if they were used to finance excluded property or relievable property in order to remove any ability to circumvent the restrictions by carefully timing the repayment of these liabilities.

Example 2

A business owner has borrowed against his home to fund his trading business. Previously, he would have been able to deduct the mortgage from the value of his home. Under the new rules, this would no longer be possible as the funds have been used to finance the maintenance or enhancement of the 'relevant business property'. The liability would therefore, under s162B(1) IHTA, reduce the value attributable to the business property before it is treated as reduced under s104 IHTA (when BPR is applied). The changes can therefore produce stark results (see table below).

One of the central stated aims of the coalition government is to create a business environment in the UK that encourages entrepreneurship. This seems at odds with the situation described in example 2 (above) in that many businessmen who have risked the security of their home to invest in their business could find that their IHT exposure could markedly increase as a result of the changes detailed in Finance Bill 2013. Similarly, farmers will be caught to the extent that they use loans on their homes to purchase, maintain or enhance farmland – a situation that many will find themselves in. The legislation also goes further, seeking to attack loans used, both 'directly' and more controversially 'indirectly', to fund the purchase of excluded or relievable property as well as those loans which are not repaid by the executors of the estate. Much will depend on HMRC's interpretation of the tracing provisions included in the legislation – for example it is not clear whether a businessman or farmer raising funds secured on their residential home that are only used to renovate commercial property or let cottages would be caught if that indirectly frees up the rental income produced by those properties to be used to finance the acquisition, maintenance or enhancement of excluded property or relievable property.

Conclusion for trust and estate practitioners

Given the potential impact of the changes highlighted above, practitioners will welcome further guidance from HMRC as to their approach in applying the new rules. Practitioners will also need to carefully review clients' affairs to confirm whether previous or proposed purchases of excluded property or relievable property will be caught under the terms of the new rules in the event of a chargeable event occurring after the Finance Bill 2013 receives royal assent later in the summer. The measures have wide ranging implications as they could adversely affect anyone conducting a trading business or a farming business (whether individuals or trustees) and limit the effectiveness of IHT reliefs (such as APR, BPR and woodlands relief). The administrative impact of these measures will not, in all likelihood, come to light until after a client dies, so positive steps will need to be taken before then so that outstanding liabilities that would otherwise be caught under the terms of the new rules are repaid, rather than left outstanding. ■

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	Old rules	**New rules**
Family home	1,000,000	1,000,000
(Mortgage used to fund business)	(600,000)	-
Net IHT value of home	**400,000**	**1,000,000**
Business	1,600,000	1,600,000
(Mortgage secured on home to fund business)	-	(600,000)
Value of business for BPR purposes	1,600,000	1,000,000
(BPR at 100%)	(1,600,000)	(1,000,000)
Gross estate	400,000	1,000,000
(Nil-rate band)	(325,000)	(325,000)
Chargeable estate	75,000	675,000
(IHT @ 40%)	**(30,000)**	**(270,000)**