INHERITANCE TAX PLANNING THROUGH TRUSTS[1]

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Introduction

1. In this article I consider recent changes and proposed changes affecting inheritance tax and particularly those relating to trusts. Finance Bill references relate to the Summer 2015 Finance Bill.

New Settled Property Charges

<u>Background - *Rysaffe*</u>

2. The use of multiple trusts as an effective IHT strategy was endorsed in the *Rysaffe* case ([2003] STC 536. *Rysaffe* planning involved setting up multiple trusts which can each benefit from their own nil rate band (subject to the settlor's chargeable lifetime gifts within seven years of the trust's creation). The planning worked as long as the trusts were set up on separate days. A simple planning strategy involved gifting a series of smaller gifts over several days.

3. More complex planning involved the creation of pilot trusts over consecutive days and making a further, larger gift, split across the pilot trusts, on the same day at a later date. This second strategy could be used as part of will planning, creating the pilot trusts during lifetime and providing for the larger gifts in the will. It is the second, more complex strategy, which is being targeted.

1 This article is simply an expression of the speaker's views, put forward for consideration and discussion. No action should be taken or refrained from in reliance on them but independent professional advice should be taken in every case.

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4. To understand how the second strategy conferred a tax benefit, we need to first recap how a ten-year and exit charge are calculated. The ten-year and exit charges include all additions to a trust since its commencement or the previous ten-year charge of that trust and, the value added to "related settlements". Crucially, when considering which trusts are related settlements, the important date is the date that the first funds were added to each trust created by the same settlor, and not the date that any subsequent funds were added to each trust. To be related, the trusts must have been created by the same settlor on the same day. If trusts are created on, for example, consecutive days, they are not related and do not need to be taken into account in any other trust's IHT calculations.

5. An example using lifetime trusts: Henry has not made any previous lifetime gifts but creates Trust A on 1 January 2015 and Trust B on 2 January 2015. Each holds £10. On day three he gifts £162,500 to Trust A and £162,500 to Trust B. Trusts A and B are not related, as they are created on separate days.

6. On 1 January 2025 (assuming there is still a nil rate band of £325,000) when Trust A is worth £200,000, there is no IHT due, as the value of each trust is covered by the nil rate band. If Trust B is also worth £200,000 on 2 January 2025, no IHT will be due.

7. If, instead, Henry had created Trusts Y and Z with £162,500 each on 1 January 2015, Trusts Y and Z would be related and the calculation for Trust Y on 1 January 2025 would be the value of the trust at the ten-year anniversary (£200,000) plus the related settlement Trust Z on 1 January 2015 (£162,500). The value subject to tax would therefore be £362,500, with the NRB deducted (£325,000) £37,500 would be subject to IHT at lifetime rates (20%), namely £7,500. Also there would be a ten-year anniversary charge of £2,250.

8. An example utilising wills. Aaron set up five trusts A, B, C, D and E on five consecutive days in June 2009 with £10 each. Aaron made no further lifetime gifts. Each trust was effectively dormant until Aaron's death in June 2014. After his IHT liability has been settled, Aaron's will leaves £1,000,000 to be split equally between trusts A – E. Each trust receives £200,000 and will have a full nil rate band going forwards.

9. At the date of the next ten-year anniversaries, when each trust is worth £300,000, no trust has any IHT liability. If, by comparison, Aaron had left the money to Trust F, which was the only pilot trust created during his lifetime, there would have been an IHT liability at the next ten-year

anniversary. If we assume that this occurs in June 2019, the calculation will be as follows.

10. The value of the trust at the ten-year anniversary is £300,000 and the NRB remains £325,000, the amount chargeable to IHT is £0. If, by contrast the value of the trust at the ten-year anniversary is £1,500,000 and the NRB £325,000, the amount chargeable to IHT is £1,175,000 at lifetime rates (20%), that is £235,000 and the tax due £35,250.

The new provisions for same day additions

11. These provisions have recently been examined in depth in the article by Robert Venables QC, so I will provide only an outline of them here with practical examples. The new section operates by aggregating the certain values of relevant property in trusts made by one settlor that are not related (i.e. not made on the same day) for the purpose of determining the rate at which inheritance tax is charged on subsequent chargeable events in those trusts, when the value of property in those trusts is increased on the same day. The provisions were contained in the Summer Finance Bill clause 11 and Schedule 1.

12. New section 62A(4) provides that a transfer of value on creation of a settlement can be a same day addition but not if settlements A and B are related settlements.

13. To give an example: George set up discretionary trust A with £10 on 1 January 2005 to benefit Emily and her family. On 2 January 2005, he set up discretionary trust B with £10 to benefit Sophia and her family. At the same time, George executed a will which instructed his executors to pay £150,000, after any IHT, to each trust. He makes no further lifetime gifts.

14. After his death in January 2020, his executors make the payment. On the second tenth anniversary of each trust in January 2025, each trust is worth £200,000. No distributions have been made. Assuming that the nil rate band remains at £325,000 and the value of the trust is £200,000, the ten-year anniversary charge in Trust A will be calculated as follows.

15. The value of the trust at the ten-year anniversary is £200,000. The same day addition to Trust B is £150,000 and the initial value of Trust B was £10. The hypothetical chargeable transfer is £350,010, the NRB remaining £325,000, means £25,010 chargeable to IHT at present lifetime rates (20%), which is £5,002 and means (at present rates) a 10 year charge of £750 (three-tenths of £5002 multiplied by twenty-fortieths).

16. The same-day addition rule has caught the gift to Trust B when calculating the IHT liability for Trust A and means that IHT will be due at the ten-year anniversary. A similar calculation is undertaken for Trust B.

17. New section 62B deals with the exceptions which include a charitable exemption and exemption where the addition results from the payment of a premium on a life insurance policy (but only if payable annually or less) and a *de minimis* provision so that additions under £5000 or less will not be a same day addition (but note only during the settlor's lifetime and not on death). It is not clear whether the situation where the settlor makes payments to the trustees to enable them to pay a life insurance premium is covered.

18. Most life policy premiums should fall within the exemption as they are regular premium policies (usually monthly, quarterly or six-monthly). This means that, even where a premium is paid on the same day as, for example, a gift to another trust, the premium will not be treated as a same day addition, and the value of the trust holding the life policy premium will not have to be included in the calculations for other trusts receiving funds on the same day. The value of the other trust will therefore not be taken into account when calculating IHT charges for the trust holding life policies.

19. With discounted gift trusts and loan trusts, as under the existing rules, care should be taken that multiple products are not opened on the same day (to avoid them being treated as related settlements). Care should now also be taken to ensure that waivers of loan repayments from loan trusts and waivers of income payments from discounted gift trusts are made on different days to avoid a settlor inadvertently falling within the "same day addition" rules.

20. In relation to pensions, following a member's death, pension death benefits are usually paid into a trust at the scheme administrator's discretion and will only become relevant property from the date that they leave the pension scheme. Unlike distributions from an executor, the date of the transfer is not read back to the date of the member's death. This means that the payment of death benefits should not be treated as same day additions, even if other trusts are created in the member's will. If a member holds multiple pensions, and the death benefits from each arrangement are paid into a separate trust, the trusts should not be related, provided each payment was made at the scheme administrator's discretion.

21. There is an anti-fragmentation clause to prevent individuals transferring amounts in excess of £5000 to settlement A in multiples of £5,000.

22. Section 62C protects certain settlements from the same day additions rules. The protection is available for settlements created before 10 December 2014 where no additions have been made after that date or the only addition is under a will executed before that date and the settlor dies before 6 April 2017. This means that existing planning will not be penalised if the settlor dies before effecting a change to their wills, and allows a window of opportunity to review all wills including this planning to ensure that they remain efficient for IHT purposes.

Amendments to the ten-yearly charge

23. Section 66 of IHTA 1984 is also amended to provide that the value of the property held on trust that is taken into account when determining the ten yearly charge includes the value of any same day additions; and the initial value of property in other trusts (other than protected and related settlements) that have increased on the same day.

24. The amendment removes the requirement to take into account the value of trust property that has never become relevant property when calculating ten year and exit charges.

25. Similar amendments are made to sections 68 (rate of tax before first ten-year anniversary) and section 69 (rate between ten-year anniversaries) and section 71F (rate on property leaving age18-25 trusts).

26. The amendments made by Schedule 1 all have effect in relation to occasions on which tax falls to be charged under Chapter 3 of Part 3 of IHTA 1984 on or after the day on which the Act is passed.

Exemption from ten-yearly charge for heritage property

27. This amendment resolves an anomaly in IHTA. In order to preserve and protect the national heritage, the government introduced the Conditional Exemption Tax Incentive Scheme. Buildings, land, works of art and other objects that qualify under the scheme are exempt from inheritance tax and capital gains tax, providing certain conditions are met. National heritage property is therefore exempt from the ten-yearly charge.

28. The current IHT legislation requires trustees to make a claim and obtain a heritage property designation before the ten-yearly charge arises. This is a

departure from the general regime for conditional exemption and can cause difficulties for trustees and parties engaged in designating heritage status.

29. The new provision (amending section 79 IHTA 1984) provides that trustees may make a claim for exemption within 2 years of the ten-yearly charge arising.

Analysis of Finance Bill IHT changes

30. While there is undoubtedly a difficult balance to be struck between maintaining a simple taxation system and one which is fair, it is surprising that, after three years and as many consultations, further headway has not been made on the simplification of inheritance tax calculations, which continue to require significant calculations in relation to historic transfers and separate settlement and effective rate calculations.

31. However, it is a vast improvement on the single trust nil rate band idea which has been abandoned.

32. The eagle eyed will have noticed that the draft legislation does not appear to have tackled an individual undertaking lifetime planning using pilot trusts where subsequent substantial gifts are made on different days during a member's lifetime, or by gifting a portion of the nil rate band to several trusts over several days.

33. In addition, trusts used to hold life policies, thanks to the specific exemption, or trusts holding pension death benefits should not be affected by the anti-avoidance provisions. Discounted gift trusts and loan trusts should also remain unaffected by the new legislation, unless the settlor inadvertently causes the trusts to receive same-day additions. For most individuals undertaking sensible inheritance tax planning, the changes to be implemented should be welcome.

Settlements with initial interests in possession

34. Clause 13 of the Finance Bill also amends section 80 IHTA 1984 to close a loophole in relation to settlements created by individuals before March 2006, which gave an interest in possession either to themselves or to their spouse, widow, civil partner or surviving civil partner.

35. Prior to the proposed amendment, a spouse's non qualifying interest in possession taken whilst the original life tenant was still alive escaped inheritance tax charges. The amendment provides that in those

circumstances the settled property is relevant property once the individual's spouse takes their life interest.

36. After representations, the clause provides that the amendments do not have effect for so long as the interest in possession (of the settlor, spouse etc.) which is in existence at Royal Assent continues and when that interest in possession comes to an end then unless the following interest is a "qualifying interest in possession" the property will be treated as becoming comprised in a settlement made by the person entitled to the subsisting interest in possession. If, on the coming to an end of the existing interest in possession, there is no qualifying interest in possession the earliest time the property will be treated as becoming comprised in the settlement is when the subsisting interest in possession ends.

Section 144 Inheritance Tax Act 1984

37. This provision resolves an anomaly in IHTA 1984 and ensures that where an appointment is made within three months of the date of death in favour of the deceased's surviving spouse or civil partner, it can be read back into the will and exemption under section 18 can be given. This was previously a trap for the unwary!

38. In *Frankland v Inland Revenue Commissioners* [1997] STC 1450, a married woman died on 26 September 1987, leaving property on discretionary trusts for the benefit of her husband and children. With considerable efficiency, on 22 December 1987 the property was transferred to a trust, the income from which was to be paid to the deceased's husband for the duration of his life.

39. The object of the transfer was to secure the benefit of the spouse exemption in section 18(1) IHTA 1984 in respect of the charge to tax otherwise payable in respect of the death. The Revenue issued a notice of determination on the basis that the spouse exemption did not apply since the transfer had not been made by the deceased. The trustee appealed, contending that the effect of section 144 was that the husband's interest in possession should be treated as having arisen under the deceased's will. The Chancery Division (Rattee J) rejected this contention and dismissed the appeal, holding that section 144 did not apply as the effect of section 65(4) IHTA 1984 was that, since the December transfer had taken place within three months of the death, that transfer itself was not an event giving rise to a charge to tax. Section 144 only applied where there was an event on which tax would otherwise be chargeable. The wording of section

144 was unambiguous. Accordingly the transfer could not be treated as having been made by the deceased, and the spouse exemption did not apply. The Court of Appeal (LJJ Peter Gibson, Thorpe and Chadwick) reaffirmed the decision.

40. Clause 14 of the Finance Bill 2015 corrects the anomalous result of this decision, so that the spouse exemption will apply in such circumstances where the death was on or after 10 December 2014. Better late (18 years!) than never.

The Increased Nil Rate Band

41. Clause 9 of the Finance Bill 2015 introduces a new additional residence nil-rate band for inheritance tax when a home is passed on death to direct descendants of the deceased on or after 6 April 2017. In outline today.

42. The maximum amount of the band will increase in stages up to £175,000 in 2020-21. Any unused band will be transferable to a spouse or civil partner. The clause also provides for a tapered withdrawal of the band for estates valued at more than £2 million. For spouses the effective maximum relief is:

	Band	Potential IHT(40%)
2017/18:	£200k	£80k
2018/19:	£250k	£100k
2019/20:	£300k	£120k
2020/21:	£350k	£140k

and the figures are subject to indexation by reference to CPI: section 8D(6)-(9) IHTA 1984.

43. At present we have the general nil-rate band. This is to remain at £325,000 until the end of 2020/2021 as provided for in clause 10 of the Finance Bill.

44. From 6 April 2017 we will also have the new *residence* nil-rate band. At the time of writing, the Finance Bill has not yet completed its passage through Parliament and there were proposed Government amendments to the residence nil-rate band provisions on 11 September 2015 (mainly to deal with the position of trusts).

45. Clause 13 inserts new sections 8D to 8L into IHTA 1984. Section 8D provides:

> *(1) Subsections (2) and (3) apply for the purpose of calculating the amount of the charge to tax under section 4 on a person's death if the person dies on or after 6 April 2017.*

46. We recall section 4(1) IHTA provides:

    On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death.

47. The new provision will take effect for relevant transfers on death on or after 6 April 2017. It will apply to reduce the tax payable by an estate on death; it will not apply to reduce the tax payable on lifetime transfers that are chargeable as a result of death (i.e. it does not apply to failed PETs).

48. Section 8D IHTA provides:

    (2) If the person's residence nil-rate amount is greater than nil, the portion of VT [VT = value transferred by the CT under section 4] that does not exceed the person's residence nil-rate amount is charged at the rate of 0%.

    (3) References in section 7(1) to the value transferred by the chargeable transfer under section 4 on the person's death are to be read as references to the remainder (if any) of VT.

49. Therefore, the residence nil-rate band (if available) is used first.

50. Section 8D(5) IHTA 1984 sets out the main parameters to be used in calculating the new residence nil-rate band and provides:

    (5) For the purposes of those sections and this section—

    (a) the "residential enhancement" is—

    (i) £100,000 for the tax year 2017-18,

    (ii) £125,000 for the tax year 2018-19,

    (iii) £150,000 for the tax year 2019-20, and

    (iv) £175,000 for the tax year 2020-21 and subsequent tax years, but this is subject to subsections (6) and (7).

    (b) the "taper threshold" is £2,000,000 for the tax year 2017-18 and subsequent tax years, but this is subject to subsections (6) and (7),

(c) TT is the taper threshold at the person's death

(d) E is the value of the person's estate immediately before the person's death,

(e) VT is the value transferred by the chargeable transfer under section on the person's death

51. Section 8D(5)(f) and (g) provide for a default allowance and adjusted allowance. The drafting is somewhat complex but it essentially provides that the default allowance is that allowed before taper relief and adjusted allowance is after taper is applied.

52. Section 8E IHTA provides:

(1) Subsections (2) to (7) apply if—

(a) the person's estate immediately before the person's death includes a qualifying residential interest, and

(b) N% of the interest is closely inherited, where N is a number—

(i) greater than 0, and

(ii) less than or equal to 100

and in those subsections "NV/100" means N% of so much (if any) of the value transferred by the transfer of value under section 4 as is attributable to the interest.

53. We are now into cold towel and gin and tonic territory (if we have resisted this so far). We have to ascertain N%, then the value transferred, then the value of the residential interest and finally the amount of value transferred attributable to the interest.

54. If, for example, you give your entire estate to your spouse, your N% will be 0 and so your NV/100 will be zero and the residence nil-rate amount is transferred in its entirety to your spouse.

55. If you give your entire estate to your children your N% is 100 and your NV/100 is the value of the house (unless the estate has debt – see more on that below).

56. If you give half your estate to your children and half to others, your N% will be 50% so it may be better to give the whole house to your children with the balance to others.Care will be needed with formulation of this.

57. Deeds of variation seeming very attractive… come on to those.

58. If the property is subject to a mortgage, that reduces the value of the property under general principles, see section 162(2) IHTA 1984. Some planning (including deathbed planning) is needed here depending on the net value.

59. Consideration will need to be given to existing nil rate band trusts where debt charged on property in estate of surviving spouse.

60. Section 8E(2)-(5) IHTA 1984 then set out four possible scenarios where the interest goes to descendants:

    60.1. Where the estate is less than the taper threshold (£2m)

    60.2. Where the estate is less than £2m and capped at the default allowance

    60.3. Where the estate is greater that £2m

    60.4. Where the estate is greater than the taper threshold and capped at the adjusted allowance.

61. These are subject to section 8E(7), which applies where the residence nil-rate amount is greater that VT (an unlikely scenario). Section 8E(7) was amended in September and provides that 8E is read:

    (2) Where—

    (a) E is less than or equal to TT, and

    (b) <u>VT</u> is less than the person's default allowance, the person's residence nil-rate amount is equal to <u>VT</u> and an amount, equal to the difference between <u>VT</u> and the person's default allowance, is available for carry-forward.

    (3) Where—

    (a) E is less than or equal to TT, and

    (b) <u>VT</u> is greater than or equal to the person's default allowance, the person's residence nil-rate amount is equal to-<u>VT</u> (and no amount is available for carry-forward).

    (4) Where—

    (a) E is greater than TT, and

    (b) <u>VT</u> is less than the person's adjusted allowance, the person's residence nil-rate amount is equal to <u>VT</u> and an

amount, equal to the difference between VT and the person's adjusted allowance, is available for carry-forward.

(5) Where—

(a) E is greater than TT, and

(b) VT is greater than or equal to the person's adjusted allowance, the person's residence nil-rate amount is equal to VT (and no amount is available for carry-forward).

62. Section 8F IHTA deals with the position where no interest in the home goes to descendants. Surely then NV/100 = 0?

63. Section 8G defines the "brought forward allowance" for a related person: that is a spouse or civil partner. Section 8G IHTA provides:

(3) P's brought-forward allowance is calculated as follows—

(a) identify each amount available for carry-forward from the death of a related person (see sections 8E and 8F, and subsections (4) and (5)),

(b) express each such amount as a percentage of the residential enhancement at the death of the related person concerned,

(c) calculate the percentage that is the total of those percentages, and

(d) the amount that is that total percentage of the residential enhancement at P's death is P's brought-forward allowance or, if that total percentage is greater than 100%, P's brought forward allowance is the amount of the residential enhancement at P's death,

but P's brought-forward allowance is nil if no claim is made under section 8L.

64. It will generally be better not to use the residential allowance on the first death, because it is worth more on the second death; however, that may change after 2021. Only one allowance is transferable (note for second marriages).

65. Also note that the bought forward allowance must be claimed by the ersonal representatives of the surviving spouse within two years of the second to die: the detail is in section 8L IHTA 1984. It will be important

to keep records on the first death. It will also be permissible to withdraw the claim.

66. If the spouse dies before 6 April 2017 section 8G IHTA provides:

(4) Where the death of a related person occurs before 6 April 2017—

(a) an amount equal to £100,000 is treated for the purposes of subsection (3) as being the amount available for carry-forward from the related person's death, but this is subject to subsection (5), and

(b) the residential enhancement at the related person's death is treated for those purposes as being £100,000.

67. Section 8G IHTA provides for taper:

(5) If the value ("RPE") of the related person's estate immediately before the related person's death is greater than £2,000,000, the amount treated under subsection (4)(a) as available for carry-forward is reduced (but not below nil) by—

$$\frac{RPE - £2{,}000{,}000}{2}$$

68. Finally, we make it to section 8H, what is, a qualifying residential interest:-

Section 8H IHTA provides:

(1) This section applies for the purposes of sections 8E and 8F.

(2) In this section "residential property interest", in relation to a person, means an interest in a dwelling-house which has been the person's residence at a time when the person's estate included that, or any other, interest in the dwelling-house.

69. The drafting is based on main private residence relief and a property which was never a residence of the deceased, such as a buy-to-let property, does not qualify.

70. If a person has only one dwelling-house that house is a qualifying residential interest in relation to that person. Where a person has residential property interests in two or more dwelling-houses, their personal representatives can nominate one (and only one).

71. Section 8H(5) provides that a dwelling house:

(a) *includes any land occupied and enjoyed with it as its garden or grounds, but*

(b) *does not include, in the case of any particular person, any trees or underwood in relation to which an election is made under section 125 [woodlands relief] as it applies in relation to that person's death.*

72. The next key provision is Section 8J IHTA 1984 which deals with what "inherited" means. It provides:

(1) *This section explains for the purposes of sections 8E and 8F whether a person ("B") inherits, from a person who has died ("D"), property which forms part of D's estate immediately before D's death.*

(2) *B inherits the property if there is a disposition of it (whether effected by will, under the law relating to intestacy or otherwise) to B.*

73. This provides a number of unanswered questions particularly in relation to assents/appropriations and sales.

74. The proposed amendments to section 8J seek to clarify the position in relation to settled property:

(3) *Subsection (2) does not apply if*

(a) *the property becomes comprised in a settlement on D's death, or*

(b) *immediately before D's death, the property was settled property in which D was beneficially entitled to an interest in possession.*

(3A) *Where the property becomes comprised in a settlement on D's death, B inherits the property if—*

(a) *B becomes beneficially entitled on D's death to an interest in possession in the property, and that interest in possession is an immediate post-death interest or a disabled person's interest, or*

(b) *the property becomes, on D's death, settled property—*

(i) *to which section 71A or 71D applies, and*

(ii) *held on trusts for the benefit of B.*

> *(3B) Where, immediately before D's death, the property was settled property in which D was beneficially entitled to in an interest in possession, B inherits the property if B becomes beneficially entitled to it on D's death.*

75. In relation to gift with reservation of benefit property section 8J IHTA 1984 provides, with some ambiguities:

> *(4) Where the property forms part of D's estate immediately before D's death as a result of the operation of section 102(3) of the Finance Act 1986 (gifts with reservation) in relation to a disposal of the property made by D by way of gift, B inherits the property if B is the person to whom the disposal was made.*

76. Section 8K IHTA 1984 (including proposed amendments) then provides what "closely" inherited means:

> *(1) In relation to the death of a person ("D") something is "closely inherited" for the purposes of sections 8E and 8F if it is inherited for those purposes (see section 8J) by-*
>
> > *(a) a lineal descendant of D,*
> >
> > *(b) a person who, at the time of D's death, is the spouse or civil partner of a lineal descendant of D, or*
> >
> > *(c) a person who—*
> >
> > > *(i) at the time of the death of a lineal descendant of D who died no later than D, was the spouse or civil partner of the lineal descendant, and*
> > >
> > > *(ii) has not, in the period beginning with the lineal descendant's death and ending with D's death, become anyone's spouse or civil partner.*

77. Stepchildren, adopted children, foster children and guardians are now all included within the definition of child.

78. In relation to a foreign domiciled testator the amount of the unused nil-rate band depends on the amount of the chargeable transfer on the death of the first spouse. If there is no chargeable transfer, the full nil-rate band is unused and is transferrable. The same should apply to the residence nil rate band.

79. Finally on this topic, downsizing relief. The Explanatory Notes to the Finance Bill 2015 provided:

56. Legislation will be included in Finance Bill 2016 to extend the benefit of the residence nil-rate band where the deceased downsized to a less valuable residence or ceased to own a residence on or after 8 July 2015...

The additional nil-rate band will also be available when a person downsizes or ceases to own a home on or after 8 July 2015 and assets of an equivalent value, up to the value of the additional nil-rate band, are passed on death to direct descendants….

The technical details of how the additional nil-rate band will be enhanced to support those who have downsized or ceased to own their home will be the subject of a consultation to be published in September 2015 ahead of the draft Finance Bill 2016.

80. The consultation document was published on 18 September. It's policy aim was stated to be:

The government recognises that individuals may wish to downsize to a smaller and often less valuable property later in life. Others may have to sell their home for a variety of reasons, for example, because they need to go into residential care. This may mean that they would lose some, or all, of the benefit of the available RNRB. However, the government intends that the new RNRB should not be introduced in such a way as to disincentivise an individual from downsizing or selling their property.

Consequently, the government announced that where part or all of the RNRB might be lost because the deceased had downsized to a less valuable residence or had ceased to own a residence the lost RNRB will still be available - provided that the qualifying conditions were met. The RNRB would apply where the residence is sold (or is no longer owned) on or after 8 July 2015. This proposal will ensure there is no disincentive to downsize or sell a home from the date the RNRB was announced at the Summer Budget.

81. The policy design so far is that:

The proposal would apply to situations where the deceased:

- *downsized to a less valuable residence and that residence, together with assets of an equivalent value to the 'lost' RNRB, has been left to direct descendants*

- *sold their only residence, and the sale proceeds, or other assets of an equivalent value, have been left to direct descendants*
- *has otherwise ceased to own their only residence, and other assets of an equivalent value have been left to direct descendants.*

The broad intention is that an estate would be eligible for the proportion of the RNRB that is foregone as a result of downsizing or disposal of the property as an addition to the RNRB that can be used on death. For the purposes of this note this will be referred to as the 'additional RNRB'.

The qualifying conditions for the additional RNRB would be broadly the same as those for the RNRB, that is the:

- *individual dies on or after 6 April 2017*
- *property disposed of must have been owned by the individual and it would have qualified for the RNRB had the individual retained it*
- *less valuable property, or other assets of an equivalent value if the property has been disposed of, are in the deceased's estate (this would also include assets which are deemed to be part of a person's estate)*
- *less valuable property, and any other assets of an equivalent value, are inherited by the individual's direct descendants on that person's death - direct descendants are the same as those in relation to the RNRB*

In addition, the following conditions would also apply:

- *the downsizing or the disposal of the property occurs after 8 July 2015*
- *subject to the condition above, there would be no time limit on the period in which the downsizing or the disposals took place before death*
- *there could be any number of downsizing moves between 8 July 2015 and the date of death of the individual*
- *downsizing would also include disposing of part of a property (including land occupied and used as a garden or grounds) or a share in it*
- *where a property is given away, assets of an equivalent value to the value of the property when the gift was made must be left to direct descendants*

- *the value of the property would be the net value i.e. after deducting any mortgage or other debts charged on the property*
- *the additional RNRB would be tapered away in the same way as the RNRB if the value of the estate at death is above £2m*
- *the additional RNRB would be applied together with the available RNRB but the total for the two would still be capped so that they would not exceed the limit of the total available RNRB for a particular year*
- *a claim would have to be made for the additional RNRB in a similar way that a claim is made to transfer any unused RNRB to the estate of a surviving spouse or civil partner.*

82. There are some specific examples in the consultation document. Some existing will forms will need reconsideration:

Example 1

A widow sells a home worth £400,000 in August 2020 and moves to a home worth £210,000. At the time of the sale the available RNRB is £350,000 as, had she died at that time, her executors would be able to make a claim to transfer all the unused RNRB from her late husband. By downsizing, she has potentially lost the chance to use £140,000 or 40% of the available RNRB which could have applied had the more valuable home not been sold.

When the widow later dies in October 2020, the home is worth £225,000 and is left to her children together with £500,000 of other assets. The estate can use an RNRB of £225,000. However, the widow was eligible for an RNRB of £350,000 had she not downsized. The estate can therefore claim an additional RNRB of 40% of the available RNRB (40% x £350,000) or £140,000. This would give a total RNRB of £365,000 (£225,000 + £140,000). But this is more than the maximum available RNRB (£350,000) so the additional RNRB is restricted to £125,000 to ensure that the total amount used does not exceed the maximum available.

In addition, the existing nil-rate band together with any transferable nil-rate band claimed from her late husband's estate can be applied to the remaining assets in the estate.

Example 2

A husband sells a home worth £300,000 in July 2020 and moves to a home worth £140,000. At the time the available RNRB is £175,000. He has *potentially lost the chance to use £35,000 or 20% of the available RNRB which could have applied had the more valuable home not been sold.*

When he dies in December 2020, the home is worth £175,000 and is left to his son with the remainder of the estate passing to his wife. The estate can use the RNRB of £175,000 to the full and since the RNRB was fully used on death, there is none to transfer to the widow. However, none of the existing nil-rate band has been used, so it can be transferred and will be available on the widow's death along with her own RNRB.

Example 3

A widower gives away his home worth £400,000 to his children in May 2020 and moves into rented 'later living' accommodation. At the time of the gift the available RNRB is £350,000. He has potentially lost the chance to use £350,000 or 100% of the available RNRB which could have applied had he not given away his home.

When he dies in February 2021, within 7 years of the gift, his estate is worth £600,000 and is split between his four children. As there is no qualifying residence in his estate, it cannot use RNRB directly. But the estate is eligible for additional RNRB up to the maximum 100% of the available RNRB at his death or £350,000.

The position for the gift of the house is considered first. RNRB only applies to the assets in the estate, so it is not available in respect of the gift of the house. However, the estate can claim the full transferable nil-rate band (TNRB) of £650,000 so there is no tax to pay on the gift of £400,000. The balance of £250,000 TNRB remains available to be set against the estate.

RNRB is applied first against the estate of £600,000, leaving a remainder of £250,000. The balance of TNRB from his late wife's estate is applied to this amount so no tax is payable as a result of the death.

83. There were two questions for consultation with a deadline for responses of 16 October 2015:

Question 1

Do any of the policy design details above or conditions need further clarification? Please illustrate the problem using examples if possible.

Question 2

What are the issues and practical difficulties which might arise when implementing the proposal and complying with the conditions?

84. Some wills will need reconsideration. In planning terms it will be important to ensure that the relief is utilized appropriately.

DOTAS and IHT

85. One of the most important proposed changes is the proposed extension of the DOTAS rules to IHT. Link to proposed legislation is: https://www.gov.uk/government/publications/draft-legislation-disclosure-of-tax-avoidance-schemes-dotas

86. It is important to remember that now being within DOTAS leads to the additional risk of an advance payment notice being issued.

87. The consultation document "Strengthening the Tax Avoidance Disclosure Regimes" published on 31 July 2014 stated that any new disclosure requirements applicable to IHT would remain tightly targeted, describe the avoidance that HMRC is interested in and would not catch planning which involves the straightforward use of reliefs and exemptions. This does not appear to be the effect of the draft regulations.

88. Proposed legislation:

Prescribed description of arrangements in relation to inheritance tax

2.—(1) For the purposes of Part 7 of the Finance Act 2004 (disclosure of tax avoidance schemes) arrangements are prescribed in relation to inheritance tax if an informed observer, having studied the arrangements and having regard to all the relevant circumstances, could reasonably be expected to conclude that—

(a) condition 1 is met, and

(b) either condition 2 or condition 3 is met.

(2) Condition 1 is that the main purpose, or one of the main purposes, of the arrangements is that a person might reasonably be expected to obtain an advantage in relation to inheritance tax ("the tax advantage").

(3) Condition 2 is that one or more elements of the arrangements would be unlikely to have been entered into but for the obtaining of the tax advantage.

(4) Condition 3 is that the arrangements involve one or more contrived or abnormal steps without which the tax advantage could not be obtained.

(5) In paragraph (3), "one or more elements of the arrangements" includes—

(a) a step or steps in the arrangements,

(b) one or more terms or conditions agreed as part of the arrangements, or

(c) the way in which the arrangements are structured.

(6) Arrangements are excepted from being prescribed under this regulation if they are specified in regulation 3.

89. The excepted arrangements are as follows:-

3.—(1) Arrangements are specified in this regulation if they comprise only of arrangements of the description in paragraph (2), (3) or (4).

(2) A person makes or amends their will or codicil.

(3) A person ("S") makes a disposition of property whereby property becomes comprised in a settlement, where—

(a) the settled property consists of, or includes, rights under a contract of insurance, and

(b) S retains only indefeasible rights under either the terms of the trust, contract of insurance or both, to—

(i) the proceeds of one or more single premium insurance policies with fixed maturity dates, or

(ii) (ii) pre-determined capital payments,

if S is alive at the prospective payment date.

(4) A person makes—

(a) a disposition of property whereby property becomes comprised in a settlement, and

(b) an interest-free, repayable on demand loan to the trustees of the settlement.

(5) In paragraphs (3) and (4), "property", "settlement" and "settled property" are to be construed in accordance with the Inheritance Tax Act 1984.

90. It is important that the DOTAS regime is not extended in a way that would require mainstream benign and inoffensive estate planning arrangements, that seek to do no more than use available reliefs and exemptions in a straightforward manner, to be reported. Conditions 1 & 2 are very wide

and will almost invariably be satisfied by any IHT planning including planning of the most straightforward type. If this was not the case then there would be no need to include in Regulation 3 a specific exemption for the making and amending of a will or codicil.

91. The following utilisation of statutory reliefs would therefore appear to be caught by Condition 2:

- making of lifetime gifts rather than gifts by will in order to benefit from the exemption after 7 years under the potentially exempt transfer rules,
- gifting assets qualifying from business property relief or agricultural property relief (rather than other assets) to younger members of the family during lifetime rather than on death,
- gifting assets qualifying from business property relief or agricultural property relief (rather than other assets) to a trust for the benefit of younger members of the family,
- creation of a trust every 7 years in order to maximise the availability of the nil rate band,
- giving assets to a younger spouse or civil partner who may have a longer life expectancy,
- trustees of relevant property trust investing in assets qualifying for business property relief or agricultural property relief which will result in a reduction of the charge at the 10-year anniversary,
- giving away a house to a family member and paying market rent to continue in occupation,
- giving away a share of a house and co-occupying with the donee,
- using a deed of variation to increase the amount passing to charity under a will so as to benefit from the reduced rate of IHT,
- use of surplus income to pay school fees for grandchildren rather than increasing the value of your estate,
- trustees of a relevant property regime settlement distributing income just before the deadline to avoid deemed accumulation,
- creating a settlement with assets which have a high growth potential whilst they have a low value.

92. In relation to Condition 3 the “test” is “contrived or abnormal steps”. What is the precise scope of this and how is it intended to interact with

GAAR? It is one of the indicia of "abusive" steps in the GAAR. (i.e. cannot reasonably be regarded as reasonable).

93. It is important to bear in mind what is, and what is not, tax avoidance. See *CIR v Willoughby* [1997] 70 TC 57: "*But it would be absurd … to describe as tax avoidance the acceptance of an offer of freedom from tax which Parliament has deliberately made. Tax avoidance … is a course of action designed to conflict with or defeat the evident intention of Parliament.*"

94. The GAAR Guidance made the following point:

"*It is recognised that under the UK's detailed tax rules taxpayers frequently have a choice as to the way in which transactions can be carried out, and that differing tax results arise depending on the choice that is made. The GAAR does not challenge such choices unless they are considered abusive. As a result in broad terms the GAAR only comes into operation when the course of action taken by the taxpayer aims to achieve a favourable tax result that Parliament did not anticipate when it introduced the tax rules in question and, critically, where that course of action cannot reasonably be regarded as reasonable.*"

95. Accordingly, a much better way of achieving the policy objective, and one which would be more consistent with how the rules work in relation to other taxes, would be to describe the sort of tax schemes which need to be disclosed rather than to introduce a hallmark which catches everything and then makes certain (slightly random) exemptions.

96. One way in which the policy objective could be more fairly achieved would be as follows:

96.1. Extend the confidentiality and premium fee hallmarks in paragraphs 6-9 of the Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2006 to IHT.

96.2. Consideration could also be given to extending the standardised tax product hallmark in paragraph 10 of those regulations to IHT but it would be necessary to consider whether certain sorts of arrangements should be excluded in paragraph 11 of those regulations. Exclusions might include, for example, wills and trusts based on standard form precedents.

96.3. Introduce new descriptions dealing with specific categories of IHT avoidance which HMRC feel should be caught.