Welcome, Succession Taxes Voice, Issue 1

Inheritance tax and trusts

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A little less voluntary

Former Chancellor of the Exchequer, Roy Jenkins, famously said that "Inheritance tax is a voluntary levy paid by those who distrust their heirs more than they dislike the taxman." Like him or not the taxman now seems determined to do something about reducing the voluntary aspects of IHT. Of course IHT was never truly completely voluntary but for many years it sat undisturbed in its own sheltered little backwater, largely undisturbed by the gathering storms of anti-avoidance measures, contributing barely one per cent of the national tax take, and the authorities seemed content to let it lie there. But then came the increases in property values of the nineties and noughties, leading to calls for the nil-rate band,which had also been neglected, to be increased in line with house price inflation, rather than RPI or CPI. Perhaps this rang a small bell in the Treasury: if enough taxpayers were concerned about paying more IHT there must be more IHT to be collected and as the appetite for IHT avoidance arrangements grew so did Government's hunger for a slice of the cake. The first sign of a shift came with new anti-avoidance measures in the mid noughties with counter measures against purchased interests in excluded property trusts of thesort covered in Edward Emblem's article. Then came the pre-owned assets tax-POAT, designed to stem the tide of arrangements designed to save assets, mainly private residences but investments too, being shifted out of individuals' estates while remaining available for their benefit – but a benefit falling outside the gift with reservation of benefit provisions. And despite the efforts (best or worst-opinion is divided and the CIOT is neutral) of tax planners, the Government's IHT 'take' continued to grow in cash terms and as a proportion of total revenues.

Then the penny, or krugerrand, dropped: if IHT was worth avoiding by those minded to, yet still turning into a money-spinner too, maybe it was time to get serious about ramping-up enforcement. Throw in a desperate need to raise revenue outside the restrictions of tax-locks and a political climate hostile to non-doms, tax avoidance and in particular tax-avoiding non-doms and the time was ripe for some serious moves to increase the IHT take.

The changing landscape

Changes in recent years include:

- curtailment of the usefulness of loans in IHT planning, as dealt with by Gary and Kristina;
- ending the long-recognised anomaly that allowed a settlor to create multiple ‘pilot’ trusts, each with its own nil-rate band – see Harriet’s article;
- further tightening of the deemed domicile rules by aligning them with income tax and capital gains tax in a new common deemed domicile régime which will diminish the attraction of excluded property trusts, covered by Ed; and
- the tight constraints on the new residence nil-rate band which, as Allan’s article makes clear, is not as simpleas the increase in the IHT threshold it is made out to be.

DOTAS – the hallmark of a tax taken seriously

Finally we have the full extension of the now long-established disclosure of tax avoidance schemes (DOTAS) rules to IHT.

IHT avoidance schemes involving confidentiality clauses or premium fees have been within DOTAS since 23 February this year and a further hallmark would have been brought in too, but for the fact that in its forst proposed form it was rejected as too wide-ranging and unfit for purpose. In its original form its scope could have treated simple gifts, the simplest of plain vanilla transactions, as potentially notifiable under DOTAS. Fortunately, HMRC has listened to the criticisms of that hallmark and largely abandoned the most contentious aspects of the new hallmark but although the new proposals in the consultation documenton disclosure of tax avoidance schemes for indirect taxes and IHT, issued on 16 April 2016, demonstrate a better understanding of the issues in IHT, they are still attracting criticism due to the breadth of their potential scope which could still, unless carefully managed and more clearly defined, result in some plain vanilla arrangements being brought into DOTAS.

Estate planning is more tutti frutti than plain vanilla

To a certain extent the problems presented by IHT derive from the structure of the tax and the arrangements potentially affected. IHT is the tax with the longest lead time between arrangements being made and taking effect: a will may be signed and then forgotten for decades, in which time both the make-up of the estate it governs, and tax law may change out of all recognition before the testator dies, while a trust can have a lifespan of up to 125 years under the present perpetuity rules.

The DOTAS conditions and how they will be applied

Turning back to the changes being made to the hallmarks, the following observations may be made:

Condition 1 “the main purpose, or one of the main purposes, of the arrangements is to enable a person to obtain a tax advantage” is uncontroversial in the present day and age.

Condition 2 “the arrangements are contrived or abnormal or involve one or more contrived or abnormal steps without which a tax advantage could not be obtained” is largely based on the Government’s original proposal for Condition 3 with some wording changes (the contentious original Condition 2 having been dropped altogether).

How Condition 2 will apply will depend on how HMRC and the Tribunals interpret the phrase “contrived or abnormal”. “Contrived” connotes artificiality and so may be thought of as less contentious than “abnormal” but both words have a breadth of meaning that extends far beyond tax. In the realm of succession planning it can be more difficult to pin down what is normal than what is not as testators and settlors of trusts are often more concerned with retaining control over assets for reasons that, as the late Mr. Jenkins observed, have nothing to do with personal benefit but reflect their creators’ wishes to protect future generations interests, the integrity of particular property such as estates, in the real property sense of the word, and the devolved assets themselves from the depredations of rogues and the feuds and follies of the beneficiaries.

Therefore wills and trusts may often contain provisions that are contrived or abnormal for non-tax reasons but which may lead to a tax advantage. The weakness of the proposed Condition 2 is that it contains no hint of a purposive test, i.e. that to the informed observer the steps:

- are contrived or abnormal;
- contribute to a tax advantage being obtained; and
- have the avoidance of tax as the sole, or a main purpose.

The informed observer test

The hallmarks depend on arrangements appearing to an “informed observer” to meet the conditions. HMRC’s view is that an informed observer is someone who is independent and has knowledge of the Taxes Acts “such as the Tribunal”. But this is not enshrined in the proposed statutory instrument and so there is no guarantee that in future HMRC’s interpretation might not suffer from mission creep.

What is needed is that the “contrived or abnormal” test be qualified in the regulations by restriction to the context of IHT.

‘Ordinary’ tax planning

However, there is, at least, clear acknowledgement in the revised consultation document that ‘ordinary’ tax planning arrangements will not need to be disclosed, with a few examples cited and the promise of high level examples being given in the revised DOTAS guidance to add clarity. It is explicitly stated that tax planning arrangements whilst making or amending a will (e.g. gifts into trust to use up the nil rate band of the settlor) do not need to be disclosed. Neither, for example, should outright gifts which use statutory reliefs, or an investment decision which takes into account the availability of business or agricultural property relief, provided there were no contrived or abnormal steps to secure those reliefs.

A number of common arrangements will also be specifically excepted from the disclosure requirement:

- loan trusts
- discounted gift scheme
- flexible reversionary trusts
- split or retained interest trusts.

In contrast, disclosure will be required for home loan schemes, where donors give away the family home whilst retaining a benefit, as this is likely to breach the gift with reservation of benefit rule.

When will the results be known?

The consultation closes on 13 July 2016 and will then lead to amendments to the DOTAS Hallmark Regulations. Therefore they do not depend on Parliament being in session and may appear during the Summer Recess. In the past changes to DOTAS regulations have been issued as soon as they were ready as they are not tax year-specific.