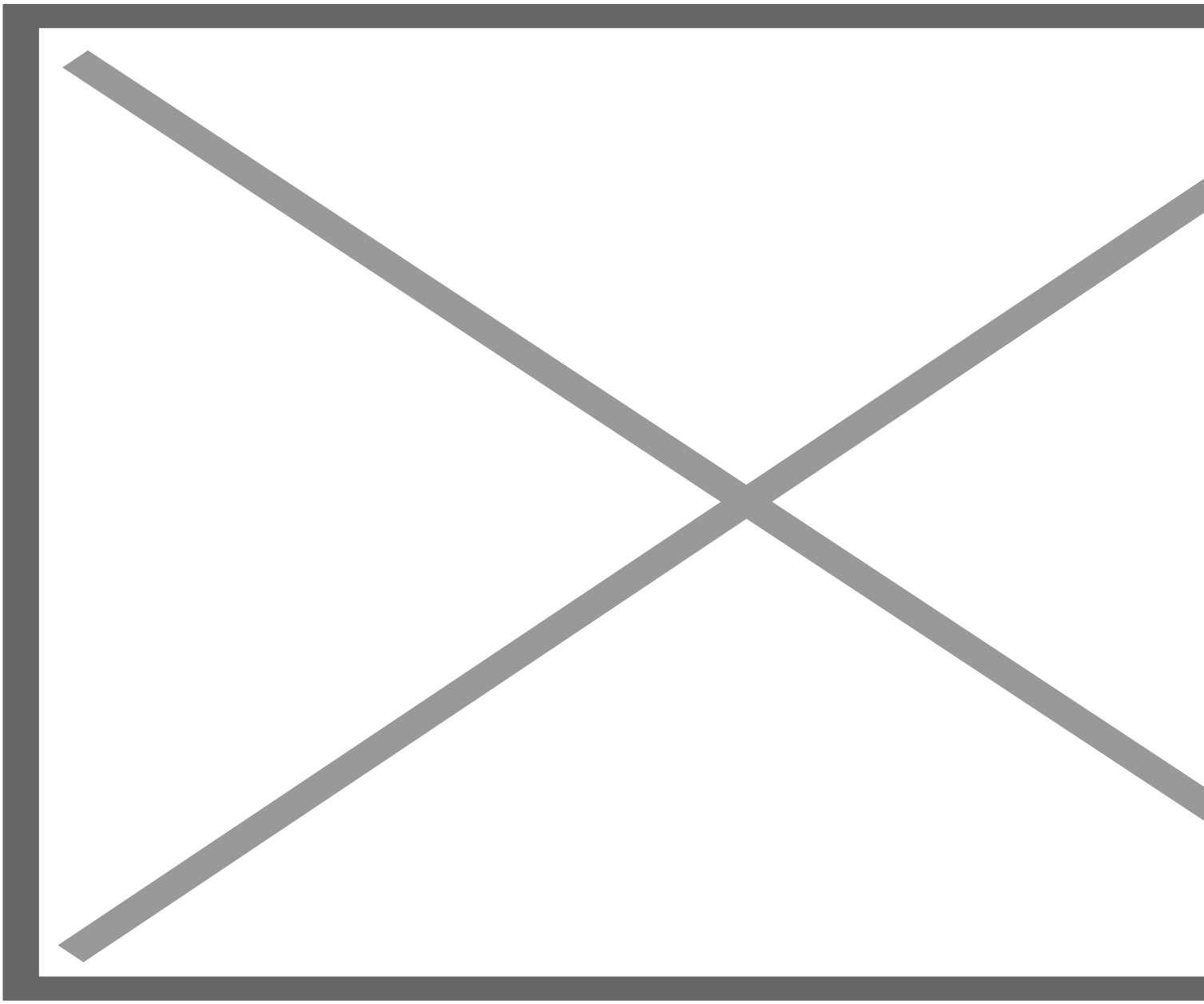
Opening the gate

Inheritance tax and trusts



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Natalie Iceton and *Dan Hartland* consider approaches for companies with trading and investment activities wishing to access BPR

Key Points

What is the issue?

Business Property relief may not be available or may be available but restricted if a company carries on both trading and investment activities. We consider approaches for tackling this problem.

What does it mean to me?

When advising shareholders who own shares in companies which undertake mixed activities a full understanding of the BPR rules and possible planning options is recommended.

What can I take away?

A high level overview of the BPR rules and conditions for shareholders where companies carry out mixed activities and discussion of the hybrid business model, finance companies and demergers.

Practical approach to a Business Property Relief problem

Let us consider a scenario. Mr E is a successful entrepreneur who has built up a business manufacturing widgets. He owns 100% of the shares in HoldCo, an unlisted holding company, which owns shares in various trading subsidiary companies. Over the years the group has been successful with surplus profits being invested via Holdco in investment portfolios managed by external fund managers and investment properties. The investment business has expanded to such an extent that it is now actively managed as part of the overall business.

Where inheritance tax is the primary concern, the key questions are whether Business Property Relief ('BPR') will be available, the extent to which any relief will be restricted as a result of the holding of excepted assets and what action can be taken to mitigate the shareholders' inheritance tax position.

Relevant Business Property

The starting point is the rules governing the availability of BPR found in IHTA 1984 s 103 et seq. The legislation includes both a gateway test as to whether BPR can apply at all and then potential restrictions if we pass through the gateway.

The gateway test precludes BPR in respect of shares in an unlisted company where the company's business 'consists wholly or mainly of…dealing in securities, stocks or shares, land or buildings or making or holding investments' (s 105(3)). If we were to stop here then our Holdco may struggle, as it is primarily holding investments and shares in subsidiary companies. However subsection s 105(4)(b) makes it clear that s 105(3) does not apply to shares of a company if the business consists wholly or mainly of being a holding company of one or more companies whose business does not fall within subsection 3.

Where BPR is available, the amount of relief is restricted where either the holding company holds an excepted asset as per s 112 or under s 111 where any of the subsidiary companies would not themselves qualify for BPR under the relevant business property test in s 105(3). An excepted asset is an asset not used wholly or mainly for the purposes of the business concerned throughout the whole of the last two years of the relevant period, nor required for future use in the business.

Therefore, where there exist investment activities we need to consider both the gateway test, which could result in BPR being unavailable, and the restrictions where it is available.

The gateway test

With regard to assessing if the shares in Holdco qualify for BPR under the gateway test, the shares and assets valuation manual provides guidance at SVM111190 which states 'the only grounds on which relief may be denied under s 105(3) are if the business of the holding and subsidiary companies viewed as a whole does not fall within s 105(4)(b). This test is a factual one.' Whilst not absolutely clear from the statutory wording, HMRC's stated approach is to 'look at the group as a whole to determine whether it is mainly investment or non-investment and then to examine each tier separately, whether top down or bottom up, to see if any restriction of the relief is required…'. It is, therefore, necessary to stand back and look at the situation 'in the round'.

The leading authority in this regard is *Farmer v IRC* (1999) SpC 216 where the Special Commissioner in reaching her decision had regard for the following factors:

- Overall context of the business
- Capital employed
- Time spent by employees and directors
- Split of turnover between trading and investment activities
- Amount of profit derived from the trading and investment parts of the business.

Passing the gateway test

If we assume that s 105(4)(b) applies to preserve BPR for the Holdco shares and all of the subsidiaries are trading, such that there is no restriction under s111, the only question is whether there is a restriction for excepted assets. Although intuitively one might expect the taxing provisions to treat the investment assets held by Holdco as excepted, this is not the case. Provided the investment activities of Holdco are sufficient to constitute an 'investment business', HMRC accept in their guidance at SVM111220 that 'it cannot be said that the investments made have not been used for the purposes of the hybrid (mainly trading, partly investment) business. Thus those investments cannot be regarded as excepted assets'. The hybrid model could, therefore, be a very tax efficient solution to Mr E and allow both the trading and investment businesses of Holdco to qualify for BPR.

As HMRC will look 'in the round' at the business activities of Holdco group, it is important that evidence is retained to support the business being run as a hybrid. For example, the background to the business, board minutes of Holdco and the narrative and presentation of Holdco's accounts should all support the carrying on of a hybrid business.

Failing the gateway test

Clearly, if the gateway test is in doubt, there is a danger that BPR will not apply and both the value of the investment assets and trading businesses will be subject to IHT on Mr E's death. In this case it may be sensible to undertake more significant action.

Reviewing the operations of the group

Where, in essence, a trading business is generating surplus cash resources which are being applied for a variety of investment purposes, it may be possible to recognise this allocation of capital as a business activity in itself via a finance company subsidiary. That is, accumulating the surplus cash in a subsidiary of Holdco before lending the cash to other group companies, third parties etc on commercial terms for the purpose of their trading and investment activities. If this additional activity qualifies for BPR then it may be sufficient, under the Farmer tests, to support a wholly or mainly argument.

The case of *Phillips and others (executors of Rhoda Phillips Deceased) v Revenue and Customs Commrs* SpC 555 found in favour of the taxpayer that a company which was lending money to related family companies could be said to be carrying on a qualifying business for BPR purposes. However, the decision was not tested at the High Court or above. If Mr E were to rely on this, then there would need to be an active lending business supported by the relevant facts and circumstances. If, however, this could be supported then it would potentially allow the group to stay intact, with both the trading and investment businesses being sheltered by BPR.

Demerger

Clearly, if it is not possible to meet the gateway test due to the relative size of the investment business, a sensible approach would be to break up the investment and trading businesses into separate groups to allow the value of the trading business, at least, to qualify for BPR. Extraction of the investment assets, without careful planning, can prove very expensive with the potential for income tax, corporation tax and SDLT charges.

A capital reduction demerger has historically been the default planning in such scenarios. Although a detailed review of such a demerger is beyond the scope of this article, for Mr E this approach would allow the trading subsidiaries to be demerged tax efficiently under a new holding company wholly owned by Mr E and established for this purpose.

One final word

Ultimately there are a variety of factors that Mr E will need to consider beyond IHT in assessing the right strategy for him. However, we hope that the above has highlighted some of the complexities and considerations associated with tackling this common problem and that extracting sizable investment assets from a group for inheritance tax purposes is not always the right answer.