The gift that keeps on … taking

Sam Hart looks into the potential tax chargeable to recipients of gifts when the donor dies within seven years of making a gift, and the relief available to donees.


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It is always nice to receive a gift – Trojan horses notwithstanding – particularly when said gifts are substantial sums of cash or assets. However, not all gifts end up being quite as generous as they might at first seem. Despite best intentions, there are cases in which gifts come with strings attached, namely a seven-year tapering liability to a potential inheritance tax charge if your benefactor is rude enough to die within seven years of making a gift. The rules apply to gifts made to individuals, which are normally potentially exempt transfers (PETs), and to chargeable lifetime transfers, but also to gifts where business property relief (BPR) has been claimed but the qualifying asset is no longer held on a donor's premature death.

Under IHTA 1984, s 3A a PET is successful and therefore exempt from all inheritance tax on the gift itself provided:

- it is made by an individual;
- the value transferred becomes comprised in the estate of another individual (or certain limited types of trust); and
- the transferor survives seven years from the date of the gift.

In practice, this means most gifts made by one individual to another individual will be PETs, unless they are exempt in some other way (eg gifts to spouses). While trustees who receive gifts that are normally immediately chargeable to inheritance tax as chargeable lifetime transfers, rather than PETs, might be more aware of the seven-year waiting period after which no additional tax can become due on a lifetime gift, individuals who have received a windfall are more likely to spend their new-found wealth.

In practice, few individual gift recipients are aware of the potential charge that can be levied on them should the donor fail to fulfil the third condition for a gift to be fully exempt. If the donor dies within seven years of the date of gift, the transfer becomes a failed PET, and the tax due must be calculated at the point the gift becomes chargeable, ie the date of death of the donor.

Although the donor's death triggers the charge to tax, for the purposes of IHTA 1984, the lifetime transfer is not treated as a transfer made on death and the previously gifted property is not deemed as part of the donor's death estate (except where a gift with reservation of benefit under FA 1986, s 102 applies).

However, the value of any failed PET is included in a cumulation calculation to determine how much nil rate band is available to offset against that gift when calculating the tax due at death rates, and how much tax is due on the estate overall. When lifetime transfers following cumulation with other lifetime gifts exceed the available nil rate band before considering the value of the estate, then tax is directly chargeable on that transfer and is described as being 'chargeable in its own right'.

Key points

- The tax due for a failed PET must be calculated at the date of death of the donor.
- If the original gift qualified for business property or agricultural relief the donee could be saved from an unexpected tax bill.
- IHTA 1984, s 113B provides for replacement property provisions to 'save' gifts from a BPR clawback.
- BPR is not available if the property is subject to a binding contract for sale at the date of the transfer.
- Case law has found that HMRC cannot simply determine two operations to be associated simply because this results in a higher tax charge.

Gift with strings attached

Let's take a simple example.

Melanie recently won the lottery, scooping £1.4m. She gives £510,000 to her daughter Amelia and spends the rest 'living it large'. Unfortunately, two years after making the gift to

Amelia, Melanie has a freak accident involving a roulette wheel, a camel and a surfboard, and sadly dies with only £15,000 to her name.

If we assume Melanie had made no previous gifts, on her death, the PET becomes a chargeable gift and tax must be calculated at death rates. After deducting Melanie's nil rate band of £325,000, and two years' annual exempt amounts of £3,000 each, the remaining £179,000 becomes chargeable in its own right at 40%. Amelia, who has spent all of the money taking her pet tortoise, Sampson to see a psychic, is now facing an inheritance tax bill of £71,600. If only she had seen that coming. The personal representatives of Melanie's estate will also have to pay a further £6,000 (£15,000 at 40%).

Note that, while Amelia is liable for the tax on the failed PET under IHTA 1984, s 199, in some limited circumstances the personal representatives of Melanie's estate can also be liable under IHTA 1984, s 204. Under s 204(8), personal representatives are liable only to the extent that either:

- no person is liable for the tax (or part of it) under IHTA 1984, s 199; or
- the tax remains unpaid 12 months after the end of the month in which the death occurs.

In practice, this is likely to be the case where the tax on the value transferred exceeds the value of the asset received by the donee or where recovery cannot be obtained from the transferee, possibly because they do not have ties to the UK. The personal representatives are unlikely to be able to obtain a certificate of clearance IHT30 while there remains unpaid tax on a failed PET.

> "One of the forestalling measures that has been popular is to gift BPR-qualifying company shares into trust before a sale."

Gifts that qualify for business property relief

What is the situation where the original gift qualified for BPR or agricultural property relief? This may save the donee from an unexpected tax bill, but only if they are also able to claim BPR at the time the gift becomes chargeable.

Take Adam. He gave his entire 35% shareholding in Angel Line Ltd, an unquoted trading company to his best friend Katie in 2021. The shares were worth £666,000 at the date of the gift. Shortly after gifting them, the value of the Angel Line Ltd shares tripled to £2m and, on hearing the news, Adam died from a heart attack in shock.

While the gift becomes chargeable on Adam's death, the gift was eligible for BPR at the date of the original transfer. Although Katie has not owned the shares for two years at the date of Adam's death, the specific relaxation of the rules relating to unquoted shares in IHTA 1984, s 113A(3) apply, and she is able to claim BPR in full so long as she still owns the shares, so no tax arises. Further, the transfer does not use Adam's nil rate band, which is available in full against Adam's death estate. If the property transferred by Adam had not been shares qualifying under s 113A, Katie would have had to fulfil the conditions for BPR in her own right, other than the minimum holding period requirement of IHTA 1984, s 106.

However, if Katie had sold the shares in Angel Line Ltd once they had increased in value but before Adam died, she would be in for a shock of her own. Now, the property she holds at the time the gift becomes chargeable (ie the cash from the sale) is not qualifying business property, such that BPR is not available to reduce the value of the original gift to nil. After deducting two annual exempt amounts, the chargeable gift is £660,000, and the first £325,000 is taxed at 0%, using Adam's nil rate band. The remaining £335,000 is chargeable to inheritance tax in its own right at 40%. Katie must pay the £134,000 to HMRC within six months of the date of Adam's death. Adam's estate will not benefit from any of his nil rate band.

Note that there are replacement property provisions in IHTA 1984, s 113B to 'save' gifts from a BPR clawback where replacement property qualifying for BPR is acquired within three years of a disposal of qualifying property, but that the replacement property must be owned *at the time* of the chargeable event, in this case, the date of Adam's death.

Gifts to trust before sale

The BPR clawback point made above has been of much heightened topical interest of late, as many business owners sought to take pre-emptive action in advance of the spring 2021 Budget. Of course, the event itself brought no significant changes to capital gains tax, although whether this was merely a stay of execution remains to be seen.

One of the forestalling measures that has been popular is to gift BPR-qualifying company shares into trust before a sale. The potential benefits are twofold.

First, the donor can choose whether to crystallise the capital gain that will arise on the transfer into trust, by deciding whether or not to claim gift holdover relief under TCGA 1992, s 260. For example if a business owner transfers £1m worth of unquoted trading company shares with a minimal base cost into trust before any future Budget he can accept the chargeable gain and potentially claim £1m of business asset disposal relief paying capital gains tax at 10%. Alternatively if that relief is restricted or capital gains tax rates were increased in a future Budget he could then make a holdover election such that his gain is transferred to the trustees.

Second, and potentially even more valuable, is the fact that transfers of unquoted trading company shares may qualify for 100% BPR on a chargeable lifetime transfer, such as a gift into most types of trust. This means that, while an individual would ordinarily be limited to being able to settle a maximum of £325,000 into trust every seven years, before incurring lifetime tax charges at 20%, where the property being transferred is relevant business property, this amount is essentially unlimited as the value will be relieved at 100%. When a sale of the business is in the offing, this means that the trust will hold shares only for a short time before they are converted to cash. In broad terms, the business owner has transferred £1m cash into a trust with no immediate tax implications.

But he is not free and clear yet. As described above, there is a possible clawback of BPR should the donor die within seven years where the donees (in this case the trustees) have disposed of the original BPR-qualifying asset. There are two further sticking points that may also catch out the unwary.

The first is the existence of IHTA 1984, s 113 which provides that property is not relevant business property for the purposes of BPR if there is a binding contract for sale at the date of the transfer, unless it is part of a share for share company purchase or a bona fide scheme of reconstruction or amalgamation. In both scenarios, the donee ends up holding shares, rather than cash.

So, at what point is there considered a binding contract for sale? In keeping with capital gains tax legislation this is taken to be the point at which a contract becomes unconditional; mere heads of terms will not be sufficient, but a contract conditional upon the acceptance of a due diligence report will be binding from the date of that acceptance. Note also that there has been a flurry of case law, *Goel and another v Grant and another (as joint administrators of Meem SL Ltd)* [2017] EWHC 2688 being just one example, that have held that an email contract can be legally binding.

Another area of historic concern has been the concept of cross options, common where a significant shareholder or partner in a business has provided for the other business owners to 'buy out' the family who would have inherited the shares/business interest. HMRC is surprisingly candid on this subject, stating in its *Inheritance Tax Manual* at IHTM 25292: 'Only most exceptionally does such an agreement constitute a binding contract for sale within IHTA 1984, s 113. For the agreement to come within IHTA 1984, s 113 it has to provide:

- for the partnership interest, or shares, of the deceased partner, or shareholder, to pass to his or her personal representatives
- that the personal representatives are *required* to sell the interest or shares to the surviving partners or shareholders
- who are *obliged* to buy the partnership interest or shares (emphasis added).

These requirements are rarely satisfied.'

Associated operations

Given the relatively narrow remit of IHTA 1984, s 113 outlined above, in theory it would be perfectly acceptable in BPR terms to transfer shares into trust the day before signing a contract for a sale of those shares. However, HMRC does have another lesser-known tool in its armoury.

Inheritance Tax Manual at IHTM 25291 states: 'Where a lifetime transfer other than a potentially exempt transfer is made shortly before a sale, you should investigate the circumstances to ensure the relief is properly due.' This includes a link to the associated operations section of the manuals.

The associated operations legislation is not new, and languishes almost at the end of IHTA 1984, s 268. On first reading, the application of the legislation appears almost too wide to contemplate but, as identified in his comprehensive article on the subject 'Associated operations' (*Taxation,* 9 December 2004, page 264), Barry McCutcheon points out that case law has sharpened the focus of the associated operations rules to a point that is actually quite narrow.

So why does HMRC refer to the associated operations rules in the context of a gift into trust immediately before sale? While the definition of associated operations in IHTA 1984, s 268 includes both an objective and subjective test to determine whether operations are indeed associated, on the widest application of the law this could almost catch any two instances in which property was bought, sold, gifted or transferred. In the case of a gift into trust and then a sale, it is conceivable that both operations could be considered associated.

Fortunately for the taxpayer, case law has found that HMRC cannot simply determine two operations to be associated merely because this results in a higher tax charge. In particular *Rysaffe Trustee Co (CI) Ltd v CIR* [2003] STC 536, the case that ultimately led to the anti-avoidance legislation on pilot trusts, found that five identical trusts created on the same day were all individual dispositions in their own right in fact and in law.

The suggestion that BPR could be denied on the first transfer simply because the shares are later sold is a flimsy premise: if at the date of the first disposition the property qualifies for BPR, it qualifies at the date of that disposition, regardless of whether entitlement to that relief is lost at a later point. However, HMRC's argument would be that the associated operations rules, assuming the transaction could be considered an associated operation, treat all the relevant dispositions as happening on the date of the last such disposition. In this case, therefore, the transfer would be treated as taking place at the date of the sale of the shares, at which point BPR would not be available.

But is it possible HMRC could attempt to use the associated disposal rules in another way in this scenario? HMRC's example of associated operations at IHTM 14821 reads:

> 'Tina has a 100% shareholding in ABC Ltd. At 11 June 2011 it is valued at £100,000.
> Tina transfers
> - a 33% holding to Steven on 11 June 2011;
> - a 33% holding to Steven on 12 June 2011; and
> - a 34% holding to Russell on 13 June 2011.
>
> 'Following Tina's death in August 2011, the loss to the estate on each transfer is individually valued at
> - £43,000;
> - £26,000; and
> - £17,000 respectively.
>
> 'A total of £86,000.
> 'The total of the individual transfers for inheritance tax (IHT) is only £86,000 but Tina had effectively given away £100,000 worth of assets.'

Planning point

When looking at transferring qualifying trading company shares into trust before a sale, wherever possible extend the time between transfer and sale to minimise the risk of a challenge under the associated operations rules. Always ensure the BPR claw back period is highlighted in any tax advice.

While this example conveniently illustrates an amount of value 'disappearing' from the inheritance tax net, which is surely the intended purpose of the associated disposals operation, is it possible that the valuation perspective may also feature in HMRC's reference to associated operations in the context of a gift into trust?

Take the example of Ian, who transfers 10% of the issued share capital in Johnson Ltd, a trading company, into a trust. In line with the diminution of value principles, the transfer of value is calculated with reference to the loss in his estate. Before the transfer he held 25%, and after the transfer he retained 15%. The value of the transfer is calculated with reference to the relevant minority discounts for those shareholdings.

If we know a sale is imminent, this knowledge will be incorporated in our valuation of Johnson Ltd. If the value of the total company is £10m, the calculation of the transfer of value might be calculated as:

- 25% x £10m x 35% = £875,000 *(65% minority discount for a 25% holding)*
- 15% x £10m x 20% = £300,000 *(80% minority discount for a 15% holding)*

This gives a transfer of value of £575,000, being the loss of value in Ian's estate. However, if we consider that the associated operation of the sale would in fact result in a valuation of the shares transferred as equal to the cash receivable on that impending sale, namely £10m x 10% = £1m, it may be that HMRC's associated operations would seek to charge an additional £425,000 value to tax. The argument would surely be that the loss to Ian's estate is the £1m foregone on sale, rather than the calculated values above.

After all that, it may be considered a moot point because, if we are looking at unquoted trading company shares, then unless the argument about BPR being unavailable on the later transaction succeeds, the original transfer will benefit from 100% BPR – assuming the conditions are satisfied. However, it is more likely to be a worthwhile endeavour for HMRC if the donor dies within seven years, such that there is a definite clawback of BPR and additional tax charged on the donee.

All this brings us neatly back to where we started. Let's hope the associated operations rules do not prove to be the Achilles' heel of pre-sale trust planning.

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