Technical Connection

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THE NEW BUDGET TIMETABLE

The new Budget timetable announced in the Autumn Statement will result in several timing changes.

Lost in the run up to the festive season was a Treasury note about how the Budget timetable is intended to change once Autumn Budgets begin in 2017 following the final Spring Budget on 8 March 2017. The main points to note are:

- The Office for Budget Responsibility will still produce two forecasts (Economic and Fiscal Outlooks) each year. Given the changes that can take place between two consecutive forecasts, this could prove problematical.

  One reason why Autumn Budgets were ditched in the 1990s was that their underlying economic assumptions could be woefully out of date by the start of the new tax year. The Treasury's note indirectly acknowledges this issue, noting that 'The government will retain the option to make changes to fiscal policy at the Spring Statement if the economic circumstances require it.'

- From Winter 2017, Finance Bills will be introduced following the Budget, with a goal of receiving Royal Assent in the Spring, *before* the start of the new tax year rather than three months afterwards. In theory, this change in timetable will help Parliament to scrutinise tax changes before most take effect. If fixed - term Parliaments continue their current cycle, this scheduling might also avoid the need for Finance Acts either side of the election date, as happened in 2015.

- Most measures proposed at a Budget will be subject to policy consultation in the Spring and publication of draft legislation in the Summer, before being legislated in the Finance Bill after the following Budget.

COMMENT

Legislating before the start of the tax year sounds good in theory, but in practice there will still be administrative problems in coping with many changes if they are not set in stone until, say, February or March.

HMRC TRUSTS AND ESTATES NEWSLETTER

The December 2016 edition of HM Revenue & Customs' Trusts and Estates Newsletter clarifies some important matters that concern trustees and personal representatives, in particular those holding shares and disposing of property.

Finance Bill 2016

Dividends received on shares held in an estate before 6 April 2016

HMRC has apparently received many queries about dividends received on shares held in an estate before 6 April 2016 and the Newsletter clarifies the tax treatment of these, namely that they will continue to be treated in tax year 2015/16 as before. This means that the beneficiary will continue to receive the non-payable tax credit that was available before the changes. Dividends received by the estate on or after 6 April 2016 will pay tax at the new dividend rate of 7.5% and estate beneficiaries will receive credit for the tax actually paid.

As a consequence there will be a different treatment for dividends received before, or on or after 6 April 2016. It is stated in the Newsletter that ‘where dividends are received in the estate before 6 April 2016 but the income is not paid over to the beneficiary until after that date then the beneficiary will receive a non-payable tax credit of 7.5% using the applicable tax rate for 2016/2017.’

The abolition of dividend tax credits: the effect on trustees of discretionary trusts

The Newsletter also clarifies that trustees of discretionary trusts will pay tax on dividend income at either 7.5% or 38.1% with no tax credit. Consequential changes have been made to section 498 Income Tax Act 2007 (operation of the tax pool) to ensure that the full amount of dividend tax goes into the tax pool as this was not provided for in the original draft of the Finance Bill, an omission that caused considerable concern to practitioners at the time.

All of these changes have effect from 6 April 2016.

Excepted estates: sales of property during the administration period

An excepted estate is one which, in general terms, is not subject to IHT because it is low value, an exempt estate as defined or, subject to satisfaction of a number of conditions, the deceased was non-UK domiciled.

HMRC has apparently received a number of letters from agents and personal representatives in connection with the sale of properties in an excepted estate some time after the date of death, where the sale price paid is higher than the figure reported to HMRC in the IHT205 return and a request is then made to treat the sale price as the IHT value of the property at the date of death, even though this may be many months or even years later. The aim in applying for substitution of a higher value on death is to reduce any capital gain on a subsequent sale of the property. The substitution of an enhanced value would have no impact for IHT purposes as an excepted estate is not subject to IHT as explained above.

The Newsletter reminds that HMRC will only consider the values of the assets in a person’s estate when IHT is due. Where an estate is returned to HMRC as an excepted estate and no IHT is due, HMRC will not have considered the value of any asset within the estate at the date of death. The District Valuer will not have agreed or ‘ascertained’ the values for tax purposes and HMRC will have accepted the figure reported in the IHT205 return without any further investigation. HMRC will therefore not amend the value of the property previously reported in the IHT205 return for a subsequent sale price.

If there is a difference between a date-of-death value and a subsequent sale value of a property for an excepted estate, the issue is whether there is a capital gain on the sale of the property in the hands of the personal representatives which should be dealt with as appropriate, i.e. the personal representatives of the estate are responsible for reporting any gains or losses made during the administration period.

It is for the personal representatives to self-assess whether there is any capital gain between the date of death and the date when the property was sold. If when selling a property after the date of death the personal representatives wish to check the value of the property at the date of death for capital gains tax purposes, HMRC offers a post-transaction valuation check for capital gains tax purposes. This is a free service.

If there is a capital gain and it is attributable to the personal representatives then, depending on the amounts involved and whether there is any tax liability, they need to make the appropriate return to HMRC about this. As a reminder, if there is a capital gain for the personal representatives, they only have to pay capital gains tax if the amount of total taxable gains in a tax year is above the annual exempt amount for that tax year.

Civil penalties

Practitioners involved in trusts and estate work should already be aware of certain penalties that are imposed for non-compliance involving an offshore matter, such as hidden income, gains or assets overseas. These penalties came into force last April (the Offshore Penalty Regime (OPR)) and are relevant to 2016/17 tax returns.

A number of changes introduced in Finance Act 2015 will now start to affect all practitioners. Firstly, the new measures expand the meaning of ‘offshore matters’ to include ‘offshore transfers’ and, secondly, where any IHT chargeable event occurs on or after 1 April 2016, any inaccurate return involving an omitted offshore asset (or offshore transfer) is within the OPR.

Additionally, there is a further penalty for both trusts and estates practitioners for moving hidden offshore assets from one territory to another, the main purpose, or one of the main purposes of which, was to prevent or delay discovery by HMRC. This penalty is 50% of the amount of the underlying OPR penalty.

COMMENT

The Newsletter, as for all those produced by HMRC Trusts and Estates from time to time, provides a useful review of the topics recently subject to a change or in need of clarification. It may also be a useful prompt when carrying out a review of clients' trusts and trustee investments.

THE INHERITANCE TAX "14 YEAR RULE"

It is commonly known that when an individual makes a gift then, provided they survive seven years from the date of making the gift, the gift will generally fall out of account for inheritance tax (IHT) purposes.

However, the 7 year rule turns into a "14 year rule" where a series of gifts are made and the settlor dies within 7 years of making such gifts. More specifically, where a chargeable lifetime transfer (CLT) is made up to 14 years before the death of the settlor which results in an inheritance tax liability on a subsequent failed potentially exempt transfer (PET) or second CLT because the first CLT was made within the 7 year period preceding that later gift – see the example below.

What follows is an explanation and example of how this "14 year rule" operates in practice.

Ignoring any exempt transfers, it is possible for an individual to make either a PET or a CLT for inheritance tax purposes. A PET is usually made outright to an individual (including a bare/absolute trust) and would not involve any immediate lifetime inheritance tax being payable. On the other hand, a CLT is usually made through the creation of a trust, which is flexible/discretionary in nature, and could result in inheritance tax being payable if the amount transferred exceeds the settlor's available nil rate band. The available nil rate band for these purposes is the current nil rate band reduced by other CLTs made by the settlor in the seven years prior to creating the trust – note PETs are ignored for this purpose.

When a PET is made during lifetime, if the person making the gift dies within 7 years it becomes chargeable. In addition, while a CLT is chargeable when made, IHT may not have been payable at the time it was made although, if death occurs within seven years of making it, there may be IHT (or additional IHT) to pay because previous PETs have been chargeable – see the example below. The important point to note is that when determining the amount of nil rate band available to set against a series of gifts it is necessary to look at all chargeable transfers made in the 7 years preceding that chargeable gift. This may then include any failed PETs - made in the 7 years before that gift – in other words you have to look back up to 14 years.

In addition, the position both upon death and during lifetime has to be determined.

This is best illustrated by an example:

Each year Bill makes use of his annual exemption of £3,000 and, in addition, Bill has made the following gifts:

18 July 2007 - £100,000 to a discretionary trust
1 October 2010 - £150,000 to his son
15 April 2012 - £150,000 to his daughter

Bill dies on 10 June 2016 leaving an estate of £400,000.
The nil rate band for 2016/17 is £325,000.

Position during lifetime

The transfer into trust on 18 July 2007 is within the nil rate band (£300,000 for 2007/2008) so no lifetime inheritance tax would have been payable.

The other two gifts to Bill's son on 1 October 2010 and daughter on 15 April 2012 are PETs so again no lifetime inheritance tax would be payable.

Position on death

The transfer into the discretionary trust on 18 July 2007 was made more than seven years ago so would not be subject to inheritance tax.

The gift to his son on 1 October 2010 has become chargeable as Bill died within seven years. However, as the cumulative total of this gift (of £150,000) and the previous gift into trust (of £100,000) is all within the nil rate band of £325,000 no inheritance tax would be payable as a result of this PET becoming chargeable on death.

The gift to his daughter on 15 April 2012 has also become chargeable as Bill died within seven years. However, in this case the earlier gifts would need to be taken into account to determine the position as follows:

PET		£150,000
Nil rate band on death	£325,000	
Less chargeable transfers in the previous seven years		
Gift into trust	(£100,000)	
Gift to son	(£150,000)	
Remaining nil rate band		£75,000
Chargeable		£75,000

Inheritance tax (£75,000 x 40%)	£30,000
Less taper relief (4/5 years)	(£12,000)
IHT payable by the daughter	£18,000

Therefore, while the transfer into trust was made nearly ten years before Bill's death it still has an impact when determining the available nil rate band which could be applied against the gift to Bill's daughter and resulted in a tax liability on the failed PET.

Note that for the purposes of calculating the IHT liability on Bill's death estate only the two PETs have an impact as the gift into trust had fallen out of account. Thus in this case the nil rate band available to apply against the death estate would be £25,000 (i.e £325,000 - £150,000 - £150,000).

COMMENT

This article should not only serve as a reminder regarding the inheritance tax treatment of lifetime gifts but also prompt advisers to explain the repercussions of the "14 year rule" to their clients prior to them planning to make a series of lifetime gifts. And, where clients are planning to make a series of gifts they should consider taking out life cover to insure against any future potential IHT liability.

IFS BRIEFING NOTE - THE PATTERN OF INHERITANCE AND ITS GROWING IMPORTANCE IN DETERMINING WEALTH

The debate about intergenerational fairness has come to the fore in recent years. The fate of Millennials (born 1980-2000) has been regularly contrasted with that of their now retiring baby boomer (1945-1965) parents who benefited from lower house prices, final salary pension schemes, rising incomes (against today's stagnation) and no university fees. The latest to examine this area is the Institute for Fiscal Studies (IFS), which has published a briefing paper on 'Inheritances and inequality across and within generations'.

The IFS research found that among current pensioners, those with the highest lifetime incomes are also those who have inherited the most across the course of their lives. These high-lifetime-income individuals are around twice as likely as low-income individuals to have inherited something, and much more likely to have inherited six figure sums. Looking ahead, the IFS sees evidence that the same pattern will be repeated: the members of younger generations with higher incomes have considerably greater chance of either having already received an inheritance or being the beneficiary of one in the future.

While the IFS says more data is needed to determine how the effect will pan out in terms of future levels of inequality, the statistics in its briefing note are still an interesting snapshot for advisers considering the opportunities offered by the estate planning market. We set them out in full below:

The importance of inherited wealth

Elderly households now have much more wealth than households of the same age a decade ago.	Among households where all members are 80 or older, average real non-pension wealth in 2012–13 was £230,000, compared with £160,000 for the same age group in 2002–03.
An increased proportion of elderly households intend to leave a large inheritance.	In 2012–13, 44% of elderly households expected to leave an inheritance of £150,000 or more, compared with just 24% in 2002–03.
Younger generations are much more likely to expect to receive an inheritance than their predecessors.	Of those born in the 1970s, 75% either have received or expect to receive an inheritance, compared with 68% of those born in the 1960s, 61% of those born in the 1950s, 55% of those born in the 1940s and less than 40% of those born in the 1930s.

Current pensioners: who inherited?

People with higher incomes over their lifetimes are also more likely to receive an inheritance.	Looking at a group of individuals born in England in the 1930s and 1940s, 64% of the highest-income fifth (top quintile) have benefited from an inheritance, compared with 32% of the lowest-income fifth (bottom quintile).

Among heirs, those with higher incomes inherit more on average.	Looking at the same group, mean inheritance among heirs averaged £150,000 for the top quintile, but less than £100,000 for everyone else. Combined with being more likely to receive an inheritance at all, this meant the top quintile inherited four times as much on average as the bottom quintile (£100,000 compared with £25,000).
Those with the highest lifetime incomes are much more likely to have received an extremely large inheritance.	Nearly 10% of those in the top lifetime income quintile have inherited more than £250,000, compared with around 1% of those in the bottom three quintiles. In other words, more than half of those who have inherited more than £250,000 are also in the top lifetime income quintile.
As a proportion of lifetime income, inheritances are largest for the highest- and lowest-income individuals.	Lifetime inheritances are 4.4% of net lifetime income for the top quintile and 3.6% for the bottom quintile, compared with around 2% for the second and third lifetime income quintiles.
These inheritances can be significant multiples of annual income from employment, particularly for low earners.	Across the group as a whole, 12% have inherited more than 5 years' worth of net earnings and 4% have inherited more than 10 years of net earnings. But among the lowest-earning fifth, those figures rise to 16% and 9% respectively.

Younger generations: who will inherit?

The wealth of elderly households is extremely unequally distributed.	The top half of households where all members are 80 or older hold 90% of the wealth, and the top 10% hold 40% of the wealth. Hence a 'lucky half' of younger households look likely to get the vast majority of the inherited wealth from the older generation.
In younger generations, those with higher current incomes are significantly more likely to have received an inheritance or expect to receive one at some point in future.	Among those born in the 1970s, 87% of those in the top income quintile have received or expect to receive an inheritance, compared with 58% of those in the bottom income quintile.
Inheritances have become more important for both low- and high-income households.	The poorest fifth of those born in the 1970s are more likely to have received or expect to receive an inheritance than the highest-income fifth of those born in the 1930s.

COMMENT

The flow of capital between generations means, in the IFS's words, that 'inherited wealth is likely to play a more important role in determining the lifetime economic resources of younger generations, with important implications for inequality and social mobility.' This could have significant political implications for the future of inheritance tax.

The current Prime Minister has focused her rhetoric on the "just-about managing" (aka JAMs) and in her first Downing Street speech said "When it comes to taxes, we'll prioritise not the wealthy, but you." That hardly suggests that IHT is going to be weakened and there have already been suggestions following the IFS note that higher estate taxes may be necessary to prevent inequality reaching unacceptable levels.

THE RESIDENCE NIL RATE BAND

The residence nil rate band (RNRB), which finally comes into being (at £100,000) in April 2017, set us thinking about the RNRB's real impact when set alongside the fact that the nil rate band has been frozen at £325,000 since April 2009 and is not due to increase until at least April 2021:

- Had the nil rate band been index-linked, for 2017/18 it would be £385,000 (based on CPI) or £405,000 (based on RPI).

- Based on Nationwide's quarterly house price data, between Q1 2009 and Q4 2016, average UK house prices rose by 37.6%, from £149,709 to £205,937.

- Average house prices do not tell the whole story, as they embrace all types of property in every location. Estates that become liable to IHT will generally have higher valued property concentrated, but not exclusively, around London and the South East. For example, the average London house price rose by 94.9% (about £230,000) between Q1 2009 and Q4 2016 (£242,678 to £473,073) while in the Outer Metropolitan Area the corresponding increase was 70.4% (about £148,000 – from £209,667 to £357,331).

- It is not only house prices which have risen strongly since April 2009. By coincidence, that time just about marked the post-financial crisis low for equity markets. For example, since 1 April 2009, the FTSE All-Share index has risen by about 95%.

- The introduction of the RNRB will slow the growth in IHT receipts, but it is not going to stop it. The OBR's Autumn 2016 Economic and Fiscal Outlook projected IHT receipts to rise from £4.7bn in 2016/17 to £5.4bn by 2021/22.

COMMENT

The RNRB will ease the inheritance tax burden for those who can meet its conditions. However, as the above numbers show, it is arguably not doing much more than indexation of the NRB would have achieved, at least for those with estates under £2m (where RNRB tapering starts). From a long-term perspective, the case for reviewing the structure of IHT – as suggested by the Office for Tax Simplification in 2011 – remains.

INCOME WITHDRAWAL RATE FOR FEBRUARY 2017

The appropriate gilt yield, used to determine the 'relevant annuity rate' from HMRC's tables for an adult member commencing income withdrawals (or reaching an income withdrawal review date), in February 2017 is 2.0%.