Technical Connection

CONTENTS

Published by Technical Connection Ltd,
7 Staple Inn, London, WC1V 7QH.
Tel: 020 7405 1600 Fax: 020 7405 1601
E-mail: enquiries@technicalconnection.co.uk
www.techlink.co.uk

CASH GIFTS TO CHILDREN FOR HOUSE PURCHASE

A recent report from Legal and General provides an insight into the extent that parents (the so-called Bank of Mum and Dad) make loans to their children to help them get on the property ladder.

In 2018, lending from the Bank of Mum and Dad came to £5.7bn For 2019, it is forecast to increase to £6.3bn with the average size of loan coming out at about £24,000. This makes families the 11th largest mortgage lenders in the UK!

The economic background to the increased difficulties faced by adult children who want to buy a house is well known. Given that the life expectancy of parents has increased so children have to wait longer to inherit, and the general feel-good factor that surrounds a lifetime gift to genuinely help the next generation, it is easy to understand why intergenerational lifetime gifting has increased.

Of course, no such problems will arise whilst all the parties enjoy an amicable relationship but should that relationship break down, or perhaps a child divorces their spouse, the parent may wish to have recourse to the original cash transferred. In such a case, the actual basis of the transfer of cash from parents to child will be critically important. In general, if it is a loan, recovery is possible. Alternatively, if it is a gift, recovery cannot be made.

Two examples of recent cases where problems have arisen were given in the Times on 31 August 2019 as follows:-

In one case a couple spent £380,000 on legal fees and costs intervening in the financial proceedings surrounding their son's divorce. The parents, distressed at the thought of their estranged daughter-in-law walking off with half the £2 million they made available to buy a house, argued that the money was an investment in the property and not a gift. The parents were unable to convince the judge that they owned an interest in the property, and lost their case. In addition, they then had to pay the daughter-in-law's legal costs.

In the other case, parents bought a house in the name of their children which they occupied with the children. At a later date the children forced a sale of the house and kept the proceeds despite the parents arguing that the original transfer of money was a loan.

So, are there any particular factors that parents should take into account before helping their children with house purchase? Two important areas are these:-

(1) However much a child may want their financial help, parents should only make a lifetime gift if they can afford it.

    It seems that more than 25% of those who have lent or given money say they are worried that they won't have enough money to live on in retirement with more than 15% realising that since making the loan/gift they have accepted a lower standard of living.

    Clearly, people should only make gifts if they are comfortable that they can afford to do so both now and in later life, as otherwise they run the risk of becoming a financial burden on their children in later life.

(2) A parent should have fully considered the terms and structure of any loan before they make it. The Times have recently reported that there are between 12 and 15 cases a month of parents taking their adult children, or the spouse of an adult child, to Court to retrieve money lent. These cases can absorb hundreds of thousands of pounds in legal costs.

These factors reaffirm the view that where a parent is considering assisting a child to purchase a property by making a financial contribution, they need to fully consider what rights they expect to have in the future.

For example, if the parent wants to be able to recover the cash in the event of a breakdown in relations with the child, or in the event of the child's divorce (ie. to prevent the child's spouse from accessing the funds), the money should be transferred as a loan. The parent could possibly take a charge on the property, which would be a second charge if a mortgage is in place. Alternatively, the parent could help the child obtain a mortgage by guaranteeing mortgage payments.

By adopting either of these approaches the parent's financial position can be secured and the 3% additional enhanced rate of SDLT can also be avoided.

If, on the other hand, the house purchase was made with the parent's name on the title deeds, whilst the parent could secure their financial position, the enhanced rate of SDLT would not be avoided on purchase if the parent owned other residential property.

COMMENT

Parents who are contemplating giving a financial helping hand to their children to buy a house should consider all financial and security issues – both those that apply now and those that might apply in the future.

ABSOLUTE TRUSTS – THE IHT TREATMENT OF PREMIUMS PAID DIRECTLY TO THE LIFE OFFICE

When a policy is subject to an absolute/bare trust, what is the inheritance tax treatment of premiums? Well, with a regular premium policy, you would expect that in most cases the premiums paid by the settlor/donor will be covered by the normal expenditure out of income exemption. If not, there is the annual (£3,000) exemption. But what if the premiums exceed or are not covered by any of these exemptions?

Typically, a short answer when considering gifts to an absolute trust is that any gift to it will be a potentially exempt transfer (PET). However, in fact this is not necessarily the case and, for an explanation, you need to look to the statutory definition of a PET in section 3A of the IHT Act 1984. This provides that a gift can be made to an individual and so be a PET

- to the extent that the value transferred is attributable to property which, by virtue of the transfer, becomes comprised in the estate of that other individual, IHT Act 1984/S3A (2)(a) or

- so far as that value is not attributable to property which becomes comprised in the estate of another person, to the extent that, by virtue of the transfer, the estate of that other individual is increased, IHT Act 1984/S3A (2)(b).

If the policy in question is a pure protection policy, say a term assurance that will never acquire a surrender value, the payment of premiums will not increase the value of the estate of the other individual; and if the payment is made directly to the life office it will never become comprised in the estate of that other individual either.

HMRC's IHT Manual includes further clarification of this issue. Section IHTM 20332 covers: Life Policies: Potentially Exempt Transfer treatment for renewal premiums: payment of premiums for policies gifted to individuals. *It should be noted that premiums paid under policies held subject to bare/absolute trusts will be treated in the same way – our italics.* IHTM 20332 confirms that the PET treatment is *'available to the extent that the value of the transferee's estate is increased. Value in this context means the open market value and is a matter for HMRC's Actuarial Team to consider. If the amount of the premium paid direct to the insurance company is more than the increase in the value of the policy, the excess will be an immediately chargeable transfer (CLT) (subject to any other available exemptions)'.*

This means that if the protection policy has no value none of the premium will be a PET if premiums are paid directly to the life office.

If this is an issue for the donor and they require all premiums to be PETs then, in order to avoid the premiums being treated as CLTs, the donor should make payment to the trustees (which will then increase the value of the trust fund and so the value of the beneficiary's estate) for the trustees to pay the premiums.

There is further clarification of the PET treatment for renewal premiums: payment of premiums for policies in accumulation and maintenance trusts or trusts for disabled persons in IHTM20331. This includes the following:

'IHTA84/S3A (3) provided that PET treatment for such premium payments before 22 March 2006 is only available to the extent that the value transferred is attributable to property which, by virtue of the transfer, becomes settled property to which IHTA84/S71 or IHTA84/S89 applies. So, if a transferor put a policy into an accumulation and maintenance trust or a trust for a disabled person and then paid the renewal premiums direct to the insurance company before 22 March 2006, PET treatment will not be available. This is because the premiums do not become settled property. That is still the position for disabled trusts where premiums are paid in this way on or after 22 March 2006, S3A (3A).

However, if the transferor made payments to the trustees before 22 March 2006 (and also on or after that date in the case of disabled trusts) and the trustees used those payments to pay the renewal premiums PET treatment is available - even if payment by the transferor was by a cheque which the trustees endorsed in favour of the insurance company. Neither the associated operations provisions nor the principle in Ramsey/Furniss should be invoked to deny PET treatment in these cases.

S71 cannot apply to property settled on or after 22 March 2006 (IHTA84/S71 (1A)) except in specific circumstances where rights under a contract of life insurance were settled on accumulation and maintenance trusts before 22 March 2006, but premiums continue to be paid after that date and further rights become comprised in the settlement as a result. In those circumstances, the payment of premiums on or after 22 March 2006 will continue to be treated as potentially exempt transfers if they are made by an individual, S46B(5) , whether the payment is made direct to the insurance company or to the trustees in the first place, who use it to pay the premiums. Where the payment is made to the trustees who then pay the premiums, we can agree that the two payments could be regarded as together comprising a disposition by the transferor by associated operations which is to be treated as a transfer of value under S3'.

COMMENT

While for the vast majority of absolute trusts premiums will be covered by one exemption or another, it is important to remember the above conditions. Of course, even if the premiums exceed the exemptions and do not qualify as PETs, there will be no immediate IHT liability on any CLT if the settlor's nil rate band is still available. On those rare occasions where an immediate IHT liability may result, it will be important to remind the settlor/donor that the payment should first be made to the trustees and this will require them to open a bank account from which the premiums will be payable to the insurance company.

TRADING OR NON-TRADING FOR THE PURPOSES OF ENTREPRENEURS' RELIEF?

In the recent case of Potter and Potter v HMRC [2019] UKFTT 554 (TC), the taxpayers equally owned all of the shares in Gatebright Ltd, which traded on the London Metal Exchange.

The company had been a successful business and had built up reserves of over £1m when the financial crash occurred in 2008. In order to safeguard its reserves, the company used around £800,000 of reserves to purchase two six year investment bonds which paid interest of £35,000 a year from 2009 to 2015.

Following the 2008 financial crash, Gatebright Ltd's trading activity in terms of volume of trades declined dramatically and the company issued its last invoice in March 2009.

While the taxpayers tried to maintain the company's trade they didn't succeed. As a result, they decided to close the company by means of a member's voluntary liquidation in November 2015.

The issue was whether the Potters could claim entrepreneurs' relief (ER) on the gain triggered by the deemed disposal on liquidation. The taxpayers claimed the relief on the basis that Gatebright Ltd had continued to be a trading company until June 2014, which was less than three years before its liquidation. However, HMRC refused the claim on the basis that no invoices were issued after March 2009 and, as a result of the crash, the company ceased to trade which meant that the company ceased to be a trading company outside the three year period in condition B of the relevant legislation (section 169I of the Taxation of Chargeable Gains Act 1992).

HMRC added: "Even if there were some trading activities, following the investment of the reserves in the bonds, the activities of the company became substantially investment activities. ER was not therefore due because the company was not a trading company as it could not be said that its activities did not include, to a substantial extent, activities other than trading activities."

The First-tier Tribunal determined that the main point to consider was whether Gatebright Ltd was a trading company after March 2009.

Mr Potter submitted that the company was not carrying on an investment business in the relevant period. The purchase of the bonds was a one-off transaction carried out to safeguard the company's accumulated profits. The First-tier Tribunal accepted Mr Potter's account of his activities after 2009 and found that the company had been carrying on trading activities with a view to reviving its trade. As such the Tribunal concluded that Gatebright Ltd was a trading company and the taxpayers were entitled to entrepreneurs' relief – so the taxpayers' appeal was allowed.

COMMENT

This case illustrates the importance of the need to understand the nature of a business to determine whether or not entrepreneurs' relief will be available – a fundamental point here was that Mr Potter was able to show that his focus was geared towards reviving the company's trade and, even though investments were purchased, these were not substantial and were a 'one-off' transaction.

A company counts as trading if its activities do not include to a substantial extent activities other than trading activities. Substantial in this context means more than 20%.

There isn't a simple formula for applying this limit, but the measures or indicators that might be taken into account include: income; asset base; expenses incurred; and time spent by employees.

This case also reminds us of the importance of the 1999 inheritance tax business [property] relief case, Farmer and another (exors of Farmer dec'd) v IRC SpC 216, in a situation where there are factors pointing both ways.

Referring to the general approach set out in the Farmer case, of considering the factors and then standing back and considering "in the round" the nature of the business, the Tribunal judge said:

"The asset and income position of the company are factors against trading activities. The expenses incurred and time spent by the directors/employees are factors pointing to trading activities. When one stands back and looks at the activities of the company as a whole and asks "what is this company actually doing?" the answer is that the activities of the company are entirely trading activities directed at reviving the company's trade and putting it in a position to take advantage of the gradual improvement in global financial conditions."

HMRC's capital gains tax manuals also refer to the Farmer case, suggesting that where some indicators point in one direction and others the opposite way: "You should weigh up the relevance of each in the context of the individual case and judge the matter "in the round"".

HIGHER RATE TAX CUTS AND THE ALTERNATIVES

A chapter from the Institute for Fiscal Studies Green Budget once again highlights the cost of the higher rate tax and NIC reforms floated by Boris Johnson.

Long, long ago, in June, when Boris Johnson was running for the Conservative Party leadership, he talked of raising the higher rate tax threshold to £80,000 and bringing the National Insurance contribution (NIC) threshold into line with the personal allowance. Subsequently, the Institute for Fiscal Studies (IFS) ran its slide rule over the costs of these two proposals and decided that they were not only costly, but also heavily biased towards higher earners.

Mr Johnson has since gone quiet on the proposals, but the IFS has now chosen to revisit them in a chapter from its Green Budget (which was published on 8 October).The chapter also examines options for supporting low earners, which is an aim the Chancellor has spoken about as part of his Budget planning. The IFS's key findings are:

- **Raising the higher rate threshold and the NIC thresholds that are aligned with it to £80,000.** The IFS reckons this would cost £9bn a year and cut taxes for the highest-income 8% of individuals, i.e. 92% would see no benefit. The threshold hike would offset some of the big tax increases that have affected the very highest earners since 2009 (additional rate, personal allowance tapering, etc).

- **Raising the higher rate threshold to £80,000 alone.** This would take 2.5m people out of higher rate tax, reversing the increase over recent decades and taking the number of higher/additional rate taxpayers to its lowest level since the UK's independent tax system began in 1990/91.

- **The tapered withdrawal of the personal allowance.** The IFS wants a more coherent approach to tax bands and views the taper as a "bizarre and opaque feature of our income tax system". It points out that the £25,000-wide 60% marginal income tax band above £100,000 is hitting ever more people each year – about 1m at the last count. The IFS alternative is to scrap the taper and instead start the additional rate of income tax at the proposed higher rate threshold of £80,000, at an additional cost to the Exchequer of about £1bn. To make the change cost neutral, the 45% threshold would have to be reduced to £75,000.

- **Raising the point at which employees and the self-employed start to pay NICs.** The IFS puts the cost of this at about £3bn for every £1,000 by which the threshold is raised. If the employer NICs threshold were raised alongside this, the total cost would be £5bn per

£1,000. Raising the NIC thresholds would benefit everyone who currently pays NICs, which the IFS says is all workers above the bottom 12% of the weekly earnings distribution (equivalent to an employee aged 25 or over working at least 20 hours per week at the national living wage).

The IFS believes an increase to the NICs threshold is the best way to help low and middle earners through the tax system. However, it says that if the aim is to help the lowest earners, increasing work allowances under universal credit would be much more effective. Only 3% of the total gains from raising the NICs threshold (either by £1,000 or to the personal allowance threshold) would accrue to the poorest 20% of households. Spending £3 billion on increasing work allowances could raise the incomes of those same households by 1.5%, compared with less than 0.1% under an equally costly NICs cut.

COMMENT

The IFS paper arrived just days after the latest borrowing figures underlined the worsening state of Government finances. If there are to be cuts to income tax and NICs, then Mr Javid's revised fiscal rules will need to be very loosely set.

TRUST STATISTICS – SEPTEMBER 2019

HMRC recently released its Trusts Statistics 2013-14 to 2017-18. Overall, the number of trusts and estates completing self-assessment returns has fallen whilst there has been an increase in the number of trusts which have been registered under the Trust Registration Service – there have been 107,500 registrations as of 5 March 2019 which was an increase of 22,500 on the previous year.

In summary, the statistics show:

- In 2017-18, trusts and estates had total income of £2.73 billion which was an increase of 12% on the previous year.
- 49,000 interest in possession trusts made self-assessment returns for the 2017-18 tax year, which was around 4,000 fewer than in 2016-17.
- 86,500 trusts paying tax at the special trust rates (trusts taxed under the relevant property regime) made self-assessment returns for the 2017-18 tax year which was also a fall of 4,000 from the previous year.
- Total income tax payable on trusts and estates in 2017-18 was £675 million - £140 million was from interest in possession trusts, £495 million from trusts taxable at the special trust rates and the remainder was from other trusts, such as charities and non-trust structures (namely estates).
- The total amount of CGT chargeable gains was £3.23 billion which was a slight increase on the previous year.

PROBATE FEE INCREASES ABANDONED

It emerged at the weekend of 12/13 October that the Government had abandoned its controversial plans to replace flat fees of £155 or £215 for probate applications in England and Wales with a sliding scale running up to £6,000. The news first appeared on Saturday morning on the Daily Mail website, which seems to have been given a briefing by Robert Buckland, the current Justice Secretary. At the time of writing, no announcement had appeared on the Ministry of Justice (MoJ) website, although the story in the Mail and later on BBC radio news was that there would now be minor adjustments as part of an annual review of all Court fees.

If you have an overwhelming feeling of dejà vu, you are not alone. The whole sorry saga is very similar to what happened in 2016/17 when the MoJ last proposed a substantial increase in probate fees. In that instance the first announcement was made in February 2016 and the climb down arrived 14 months later, as an Election loomed into view.

On this occasion the timescale has been shorter, but more frustrating. The revised proposals came out in November and by early February had reached the point of a Statutory instrument that gained a 9-8 approval by the House of Commons Fourteenth Delegated Legislation Committee. From that stage everything went quiet, other than at probate offices which were swamped with applications leading to long delays. This weekend's announcement may, like the 2017 abandonment, have more than a passing connection with an impending General Election.

COMMENT

Last November's explanatory memorandum suggested that the fee increases would yield £145m of additional income in 2019/20. Given the amount of increased spending the Government has promised in recent weeks, the Chancellor will hardly notice the loss.

INCOME WITHDRAWAL RATE FOR OCTOBER 2019

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 October 2019 is 1.0%.