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Looking a Gift Horse in the Mouth – The “Discounted Gift Scheme” for Inheritance Tax.



Much ingenuity and effort goes into trying to minimise the bite that inheritance tax (IHT) will take out of your assets when you die. On your death, your estate will be valued and the first £325,000 will be taxed at nil% (the “nil rate band”, or NRB). Any value above this “nil rate band” will be taxed at 40%.

There are various strategies to reduce this burden – my personal favourite is known in the trade as “SKI”, which means “spend the kids’ inheritance”, on the principle that if I’ve already spent it by the time I die, there will be nothing for HMRC to get their teeth into!

Those with a more responsible attitude towards the next generation often consider making gifts during their lifetimes. If you make a gift (to your children, for example) this is known as a “potentially exempt transfer” (PET), because provided you survive for seven years from the date of the gift, it is ignored when valuing your estate. If you are unfortunate enough to die during the seven years, it is a “failed PET”, and the value given away is still counted as being

part of your estate at death.

In addition to being extra careful when crossing the road for the next seven years, you must also ensure that you do not continue to benefit from the PET because if you do, it will not be a PET and will instead be a GWROB (a “gift with reservation of benefit”). A GWROB remains part of your estate for as long as you continue to benefit from it. If you cease to take any benefit, it then becomes a PET and the seven year clock starts at that point.

What exactly is a “reservation of benefit”? The classic example which I see only too often, typically in cases where the family has decided to do their own IHT planning without the benefit of expert advice, is where the parent gifts the house to the children and then continues to live in it without paying a market rent to the children. The value of the house will still be included in their estate when they die, if they are still living there at the time, or moved out less than seven years before they died.

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Many people I advise about IHT have a similar profile as far as their assets are concerned: they have a house which on its own is worth all or nearly all of the £325,000 NRB, and cash invested in the building society or the bank. They cannot give away the house because they want to carry on living in it, and they cannot afford to give away the cash because they rely on the income it produces for them.

This is where the "discounted gift scheme" (DGS) comes in. Broadly, it is a way of giving away cash in such a manner that you can still get an "income" from it, but without the gift being treated as a GWROB.

I should say at this point that in this article I am concerned with single individuals, rather than those who are married or in a civil partnership. This is because although a DGS works for couples as well, somewhat different considerations apply and the planning for IHT is radically different.

A DGS works like this: You use the cash to buy a bond (which is simply a legal instrument to hold the investment you have made) and the rights to the income and capital of the bond belong to your children (or whoever you wish to benefit). You, however, have retained certain rights for yourself. Typically, these involve the right to be repaid a certain percentage of the capital gifted each year – 5% is the usual amount, because up to 5% of capital a year can be withdrawn from these bonds without it being liable to any income tax.

Provided the terms of the arrangement have been properly drafted, the rights you have retained are separate from the gift of the bond to the kids, and there is no GWROB. The value gifted will be out of your estate after seven years, despite the fact that you are receiving what feels very like an income of 5% per year from it, on which you pay no tax.

It gets better. The value of a gift for IHT purposes is calculated on the principle of the "loss to the estate". This means the amount that will be treated as part of your estate if you die within the seven year "quarantine" period is not the amount you put into the bond; instead, it is that amount less the value of your right to 5% repayments each year.

This is easiest to understand if we look at some numbers. If you put £100,000 into a DGS bond, the amount you have given away is £100,000 minus the open market value of the right to receive £5,000 per year for the rest of your life.

How much would you pay for the right to receive £5,000 per year, if it would end on the death of another person? You would need to do some rather cold-blooded calculations based on how long you thought the person concerned was likely to survive.

The younger and fitter they were, the more you would pay.

On the basis of the figures from an example recently published by HMRC, if an 80 year old woman in good health set up a DGS of £100,000, the value of her right to 5% per year would be £46,300. To put it another way, the calculation assumes she is probably good for about another nine or ten years. This means that the loss to her estate (the amount that will be included for IHT if she does not live for seven years) is £100,000 minus £46,300, or £53,700. In terms of IHT, that is £21,480 instead of £40,000.

Properly implemented, and at the right stage in a person's life, a DGS therefore has two advantages:

- It enables you to give money away and still get an "income" from it
- It reduces the amount that will fall into IHT if you do not manage to survive for seven years after setting it up

Caveat – Don't try this at home! A DGS needs to be very carefully set up in order to ensure that it produces the desired effect for tax purposes.

Q&A

Q.1. I am aware that if you inherited a property, you use its market value on the date of death of the person who left it to you when calculating CGT in a later sale. But who decides upon the market value of the property at this time. Estate agents' estimates can vary widely. Does one have to get a number of valuations and select the average or highest?

A.1. The usual method is to get a professional valuation. It is open to HMRC to dispute this, but there is little point in getting more than one valuation. If IHT was payable on the property on the death of the person who left it to you, then the value agreed for IHT is the "cost" for CGT purposes, but beware - this only applies where the value of the property was relevant for IHT purposes. On a legacy to a spouse, for example, which is exempt from IHT, the value will not have been "ascertained" for IHT and HMRC can revisit the issue for CGT purposes.

Q.2. I bought a 2nd home in 2000 and lived there for 3 years with my disabled student child. In 2003 she wanted to try and live without me as her carer so I rented part of the house to a tenant and I returned to my marital home. I have paid income tax on the rental income but am unsure of the new rules on CGT re: lettings relief if I ever sold the 2nd property. I know that taper relief has ended and that all chargeable capital is taxed at 18%, could I give half the house to my husband so we could use both CGT allowances?

A.2. A married couple can only have one "main residence" so much depends on which property was your and your husband's main residence. On the facts, it sounds as if this would be the marital home. Had you made an election within two years of purchasing the second home for it to be treated as your main residence, you could have nominated the second home, but unfortunately the two year time limit for this is strictly enforced so it is now too late. Letting relief only applies to a property that has at some stage been your "main residence" for tax purposes, so it may not be available to you on the second home. I do not really have enough information to be certain about this, and it would be worth your while to ask a tax adviser for an opinion on whether the second home could be regarded as your main residence. Giving half the property to your husband before selling it would enable him to use his annual exempt amount, but if there is a

large mortgage on the property you need to consider the SDLT cost - again, ask a tax adviser.

Q.3. What would be the implication with regard to capital gains tax when turning our home into two flats, one of which we would still live in and the other for sale or rental purposes?

A.3. This raises some quite complex tax issues and you should take professional advice on the details, but broadly speaking if you sell one flat immediately after the conversion work is complete you will be liable to CGT on the part of the capital gain you make which is attributable to the conversion work. If instead you let this flat for some years before you sell it, then the gain attributable to the period it was let will of course not be exempt (except for the last three years of ownership, which will, apart from that part attributable to the conversion as above). Because the property has been let, however, up to £40K of the gain may be exempt (this is £40K per owner, so if jointly owned, the exemption could be worth up to £80K). As you can see, I meant it when I said take advice!

Q.4. My wife & I own a main residence (£350,000). We have planning permission to convert to 3 flats worth £150,000 each. To reduce CGT we intend to gift a third of the property to each of our two sons before the conversion. One of the sons lives with us & the other owns & lives in his own flat. After conversion, we would carry on living in one flat & each son would own the other two. What CGT would we be liable for?

A.4. See the answer to question 3 above for the broad principles involved, but in your case as you are not selling or letting the property, no tax is likely to be payable. You will be deemed to have disposed of the shares in the property given to your sons at their market value but assuming the property has always been your main residence the whole gain will be exempt. It is important that you gift the specific flat he will live in to each son, rather than simply a third share in the undivided property, and you will need a good lawyer to do the necessary paperwork for this because it will need to take account of a conversion that has yet to take place!. You should also bear in mind that should you die within seven years of making these gifts, the value of the 2/3 given away will remain part of your estate for inheritance tax purposes.

A Capital Idea? The Temporary First Year Allowance for Plant and Machinery.

Alastair Darling said in his Budget Speech that he would be “doubling” the rate of capital allowances on plant and machinery (“P&M”). As usual, once the fine print became available, the reality was not quite so generous, but nevertheless, larger businesses will be able to get tax relief for some of their capital expenditure at a faster rate than they might otherwise have enjoyed.

Generally speaking, when a business buys P&M, this will qualify as capital expenditure and as such cannot simply be deducted as an expense in the same way as, for example, wages or rent. Instead, there is a complex system of “capital allowances”, which allows the business to claim relief for the expenditure over a period of time.

The rate at which relief can be claimed depends on the nature of the P&M. Cars have their own special regime which was described in last December’s Tax Insider, and nothing in this article applies to cars. For most other P&M, there are the following allowances:

The Annual Investment Allowance (“AIA”)

The first £50,000 of expenditure on P&M in the year can be claimed in full. In the case of a group of companies or “related” businesses where much the same people own more than one business, the £50,000 is shared out among all the companies or businesses involved, but a single company or sole trader/partnership can claim the full £50,000. There is a nasty technical exception in the case of a partnership where one of the partners is a company, but those involved in such complex structures will probably know all about this.

Expenditure over £50,000 in the year goes into one of two “pools”, depending on what type of P&M is involved:

The 10% Pool

This includes “long life” P&M – this is P&M with an “expected useful life” of more than 25 years when new. Not many types of P&M fall within this definition – the classic example is a printing press. There are various exceptions to this rule as well, and most businesses will not have a problem with it.

The more common forms of P&M in the 10% pool are features “integral” to a building. There is a list of specific types of P&M which fall into this category:

- Electrical systems

- Cold water systems
- Heating and ventilation systems, including air conditioning
- Lifts, escalators and moving walkways
- Solar shading
- Active facades (what these are has been explained to me several times, but I still don’t really understand).

This list is exhaustive – that is to say, if it’s not on the list, it isn’t “integral” plant and doesn’t go into the 10% pool.

Finally, and again with a number of exceptions, assets used for a business of leasing go into the 10% pool.

The 20% Pool

Everything else, being the majority of P&M, goes into the 20% pool. Here we find computers, drills, lawnmowers, milling machines, horses (yes, horses, and there is a tax case to prove it!), tables and chairs, filing cabinets, telephones, and all the other stuff you need to run a business.

Writing Down Allowances

Expenditure in either of the “pools” is written down at the rate applicable to the pool, at 10% or 20%. You take the value of the pool at the start of the year, add in expenditure during the year over and above that which got the AIA of £50,000, and deduct the sale proceeds of any P&M sold in the year. You then claim a deduction of 10% or 20% of the amount against your profits.

For example, suppose Farmer Giles buys a combine harvester for £100,000. The first £50,000 gets allowed in full under the AIA, and the remaining £50,000 goes into the 20% pool, where it is written down at a rate of 20%. Farmer Giles therefore claims a deduction of £50,000 plus 20% of the other £50,000 = £10,000. His total allowances on the combine harvester in the year he buys it are £60,000, and the remaining £40,000 is carried forward to next year, when another 20% (£8,000) can be claimed, and so on.

The Temporary FYA

In the Budget, it was announced that expenditure on P&M which goes into the 20% pool would qualify for an extra “first year allowance” of 40%. This only applies to expenditure incurred during the period from 1 April 2009 to 31 March 2010 (for companies),

or during the tax year ending on 5 April 2010 for sole traders and partnerships.

Looking at Farmer Giles again, if he bought his combine harvester during that period, he would get the AIA of £50,000, and on the balance of £50,000 that goes into the pool, another 40% (£20,000). His total allowances for the year are therefore £70,000, an increase of £10,000 on the previous position.

Just how excited Farmer Giles will be about this additional allowance, which in cash terms is worth £4,100 to him if he is a sole trader or partner paying tax at the top rate, and as little as £2,100 if he farms using a company, remains to be seen, bearing in mind that all this is only an acceleration of allowances he would get anyway – next year, the balance of the cost of the combine harvester will be £30,000, on which he will get the 20% allowance of £6,000.

Expenditure “incurred”

One point for Farmer Giles to watch is exactly when expenditure is “incurred” for these purposes. This is not necessarily when he writes the cheque. Expenditure on P&M is “incurred” when the obligation to pay becomes unconditional – typically, when the machine is delivered. Provided the credit period after that is no longer than four months, then the expenditure is “incurred” when the obligation becomes unconditional, even if Farmer Giles does not have to get out his chequebook for another 30 days or so. If the credit period is longer than four months, however, he will “incur” the expenditure when he actually pays.

Ownership

The other little wrinkle that can cause problems is that to claim capital allowances, the P&M must become your property before the end of the period concerned (so, for the new FYA, before 1 April or 6 April 2010, depending on your business structure). Many sales agreements for expensive and complicated kit include a clause saying that title to the goods will not pass until payment has been received in full. Farmer Giles may take delivery of his new combine on 20 March 2010, and pay for it within the credit period of (say) 30 days, but if there is a “title” clause like the one described, he will miss out on his 40% FYA because the combine harvester does not strictly “belong” to him by 5 April 2010, as he has yet to make payment in full.

To Err is Human; to Forgive, Divine – HMRC Delays and ESC A19

In 1983, HMRC introduced a new computer system for PAYE. In 2005, they finally realised that it had not been working properly for over 400,000 pensioners, and as a result about three billion pounds of income tax had not been collected from their pensions.

HMRC came clean about this in the summer of 2007, and announced that although they would be putting things right for 2007/08, they would not be trying to collect unpaid tax for the previous 15 years.

This magnanimous gesture on their part was of course partly because it was unthinkable to impose huge tax demands on some of the poorest people in society, but it was also simply the operation of an “Extra Statutory Concession” called ESC A19.

ESC A19 is subtitled “Giving up tax where there are Revenue delays in using information”, and it does more or less what it says on the tin, though as always there are a number of conditions that must be present for the Concession to operate.

The Concession only applies to income tax and capital gains tax payable by individuals, not to corporation tax on company profits, and it operates if tax has not been collected on time due to HMRC’s “failure to make proper and timely use of information”.

The information could be from an individual’s tax return or even from a letter or phone call made to HMRC, or from his employer, if it affected the tax code allocated to an employee, or from the Pension Service if it relates to the State Pension.

There are various conditions. Broadly, HMRC must have failed to use information about extra tax being due for more than a year after the end of the tax year in which they were given that information and it must be the case that the taxpayer concerned “could reasonably have believed that his or her tax affairs were in order”.

In some cases, tax will be written off even if HMRC become aware of it less than a year after the end of the relevant tax year. This applies in cases where they have failed more than once to act on the information or where their negligence has allowed the tax arrears to build up for more than two tax

years in succession.

The tricky part of these conditions can be the “reasonable belief” one. If you know that HMRC has made a mistake and either not taxed you enough or repaid too much tax to you, you have a legal duty to tell them about it. This sometimes comes as a shock to clients who have benefited from HMRC’s incompetence and (for example) received too large a repayment. They tend to see this as a piece of good fortune which goes some way to redressing the balance in their favour, and it upsets them when I have to explain that unless they give it back they will be committing a criminal offence under the Theft Act!

If, however, the situation is less clear cut and in the circumstances the taxpayer could not be expected to have realised that he had paid too little tax, then ESC A19 means that at worst he will only be caught for this year’s and last year’s underpayments.

Two of the commonest examples of the problem are pensions (as described above), and company cars. If your employer provides you with a company car, you are liable to income tax on a benefit in kind, calculated on the basis of a percentage of the list price of the car when new. The percentage varies according to the CO2 emissions of the car concerned, and whether it runs on petrol or diesel. In other words, it is very complicated! Your employer is supposed to send in a form to notify HMRC when he first provides you with a car, and HMRC are supposed to alter your PAYE code to collect the tax due out of your monthly salary. Often, this does not happen, and the tax is collected out of next year’s salary, together with the tax on the same car for that year as well. This level of delay does not qualify for ESC A19, because the delay has not gone on for more than a year after the end of the first tax year.

In a case where the PAYE code is not altered for over two years, however, ESC A19 should drop the earliest year out of account, provided you “could reasonably have believed” you were paying the right amount of tax.

Fortunately, although they will not come right out and say it, HMRC seem to accept the argument that a typical PAYE coding notice is so badly designed and poorly explained

Tax Tips

- If your spouse died and left everything to you, so that none of their inheritance tax “nil rate band” was used (see the July 2008 Tax Insider for details), you can effectively double your own nil rate band on your death. There has been an exemption from IHT for armed forces personnel killed on active service since 1952, and before that the exemption was more complicated but available in many cases. If your spouse was killed in action HMRC’s “Inheritance Tax and Trusts Newsletter” for April 2009 (<http://www.hmrc.gov.uk/cto/newsletter.htm>) contains more detail on how this will affect your right to the “transferable nil rate band” and how to claim it.
- When you look at the rate of tax you are paying, the key fact is not the so-called “headline” rate – which is 40% for the top level of income at the moment, and will be 50% after next April. The really interesting rate is the “marginal” rate – the amount of tax you pay on every pound extra you make. Because of the withdrawal of personal allowances announced in the Budget for incomes over £100,000, after April 2010 the “marginal” rate on income between £100,000 and £113,000 will be 60% (61% if the income is earned rather than investment income), which is even higher than the much trumpeted 50% rate that will apply to income over £150,000. 61% on earned income is higher than the top rate was in 1979, the last time the Labour Party lost an election.
- Under the new penalty rules for tax returns for 2008/09 onwards, HMRC will either not charge a penalty, or charge a greatly reduced one, where you have taken “reasonable care” to get the return correct. They are now planning to publish a series of “toolkits” on “risks to compliance” in various common tax scenarios such as capital gains, corporation tax rates, and capital allowances. They have explicitly stated that using the toolkits will be evidence you took reasonable care when completing your return, so if you do not use them and you make a mistake the inference is obvious. Now that’s what I call effective marketing!

that no “reasonable” person could be expected to understand it. Even if you use an accountant to deal with your tax affairs, the argument to run with HMRC is that this is even more reason for you to “reasonably” believe you were paying the right amount of tax, because your accountant did not alert you to the problem.

So if you get an unexpected demand for back taxes from HMRC, always consider whether you can use ESC A19 to at least reduce the amount you have to pay!

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