

## Wipe out your Inheritance Tax - At a Single Stroke

Although death is inevitable, inheritance tax, that ghoulish, macabre tax which counts days of survival and looks at a person's whole life and assets at the point of death, is by no means something that one needs to view in the same fatalistic manner.

Inheritance tax is avoidable, and this month's article is all about what can be a very dramatic inheritance tax mitigation strategy indeed.

Although the property tide is receding a little down the beach at the moment, an enormous amount of potential rich pickings for the government, in the form of inheritance tax, is derived from the value of people's property portfolios. Property being a commodity with a strictly limited supply, and the population of these islands steadily growing, property is always going to be a very valuable asset, and increases in value over future years, on the basis of past experience, are almost guaranteed.

So, for a long time, those who wish to get significantly rich have chosen the property option as a method of doing so.

But there are two ways of dealing with property: you can either slowly and surely build up a portfolio of investment properties, whose main purpose is to provide you with a rental income, or you can buy, develop, and sell on an active basis.

## **A Crucial Distinction**

The distinction between these two ways of buying, owning and selling property is absolutely crucial for inheritance tax. Whereas holding property for rent means that the value of the property is fully taxable in the owner's estate, the conduct of a property development business, in sharp contrast, makes the value eligible for 100% business property relief – that is, the property value isn't taxed at all.

## **A Change of Direction**

The simple logic therefore is, if you or an aged parent are facing a large inheritance tax liability calculated at the rate of 40% of the value of their property portfolio, a change of approach with regard to that portfolio could convert it from being a fully taxable investment asset into the trading stock of a property development trade.

Assuming you want to do this (and some tax “pros and cons” are listed below) there are a number of things you can do to ram home the point. This may become important if an Inspector of Taxes, after the death concerned, decides to challenge the status of property business as one of property development rather than investment.

Trivial though it may sound, give the business a name which suggests development, for example “XYZ Developments”

Move the properties into a special purpose development vehicle. An LLP can be suitable for this, as, if you get the paperwork and arrangements right, the change can be done without triggering tax liabilities.

Hold appropriate meetings, properly minuted, to show the change of intention from investment to more active exploitation of the property portfolio.

Explore the market both for sales and purchases of property, and preferably become more frequent in purchases and sales (providing there is an element of improvement or “development” between purchase and sale).

If appropriate, take out bank overdraft finance which is associated with a trading activity rather than an investment activity.

Ensure that the activity is accounted for as a trading rather than an investment activity, that is show the properties as stock rather than fixed assets, and show sales of property as turnover rather than disposal of fixed assets.

## **A “Part and Part” Approach**

One interesting feature of inheritance tax business property relief is the fact that a business does not have to be 100% trading in order to qualify for relief. The way the rules are worded, in fact, means that only just over 50% of the activities need to be trading. So if you have a hard core of properties that really are investment in nature and would not make commercial

sense to treat otherwise, this is not necessarily fatal to the idea, providing these properties are in value, income, and management time requirement, less than 50% of the totality.

## **The Catch**

One major drawback to the whole idea has to be considered, though. This is that, if you hold the properties directly in your own name, rather than, say, through a company, the trading treatment has a knock on effect on the taxation of profits you actually realise when you buy and sell properties. This is a new problem, particularly, following the changes to capital gains tax so unexpectedly put through in the 2008 Budget. With capital gains tax now at 18%, it makes an awful lot more sense to make profits on selling investment assets rather than making trading profits on selling stock. Trading profits are chargeable to tax at 40% (assuming you are a higher rate taxpayer) whereas capital gains get away with less than half this tax rate.

So does this make everything we said before pointless? Not at all.

If properties are held through a limited company, which is a very frequent situation in practice, the rate of tax on profits is very similar, with the only advantage of investment treatment being the availability of “indexation allowance”. This may or may not be a significant element depending on how long the properties have been held. If the properties have been held for a long time prior to the change of strategy mentioned above, then you can effectively

“bank” the indexation allowance by a process known as “appropriating to trading stock”. The capital gain that is deemed to arise when this happens can be rolled over into the cost of the stock for purposes for future taxation of profits purposes, and of course the gain that is rolled over is that with the benefit of indexation.

Property companies are probably more suited to the kind of planning strategy we are looking at here in any event, because the existence of a company suggests a serious active business intent more than direct holding of properties.

### **Too Good to be True?**

But is it really as easy as all that? By making a few cosmetic changes, can you really change the shares in your family property company from fully taxable assets to tax free assets? Won't the Revenue cry foul?

This sort of objection, whilst it is instinctively raised by those who don't specialise in tax, is well wide of the mark in our view. Tax is not levied on the basis of what the taxman would like you to do, but what you actually have done. The relief for trading businesses is there for a policy reason, which presumably is that those actively trading “deserve” more to be able to pass that trade on without the depredation of death duties than those who are merely sitting back and receiving an investment income. So, if you genuinely change your tune from the sitting back arrangement to the active arrangement, you deserve the relief you get.

Another important point to make is that the distinction between trading and investing in property, whilst evidenced by external factors like those we've listed, is really a question of intention. That is, it's what is going on in the minds of those in control of the activity which ultimately decides the tax treatment. Bizarre, perhaps, but true.

In practical terms, where you have a family property company, say, the active exploitation of the portfolio does not, of course, need to be that of the aged relative whose potential inheritance tax exposure we are worrying about. The younger generation or generations can ensure that the property activity is carried on with sufficient input of time and effort to characterise the activity as trading. So it is possible and indeed seems to us a very good idea at least to consider this option! It could make £millions of difference in the right circumstances.

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