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Changes to Inheritance Tax and the Deduction of Liabilities

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INTRODUCTION

In this year's Budget, the government introduced changes as to how inheritance tax (IHT) will be calculated on the value of a death estate. IHT is calculated on the net value of an estate, that is to say it is calculated on the value of total assets after a deduction of liabilities. The changes will restrict the deduction of certain liabilities, which will mean that some individuals and trusts will face a increased exposure to IHT.

THE NEW MEASURES:

The Finance Bill introduces new measures with the following effect:

A deduction for a liability outstanding on death will only be allowed if it is repaid, or if there is a commercial reason for the liability to remain outstanding (and which is not part of a tax saving arrangement).

A deduction for a liability will be denied where the liability is used to finance the acquisition of property outside the charge of IHT. This will generally only apply to those who have a non-UK domicile and benefit from the rules for excluded property. In some circumstances, a deduction will be allowed if the value of the acquired property reduces. The deduction available is the excess of the liability over the value of the property.

Where a liability is used to acquire IHT favoured assets (for example, assets which qualify for business property relief, agricultural property relief or woodlands relief), the liability will be matched against the value of the qualifying assets, and not from other assets. (Where a liability exceeds the value of qualifying assets, the excess may be deductible subject to the new requirement that it is repaid after death).

The second and third measures will also apply to trusts for the purposes of calculating IHT principal charges (every ten years). Where relevant, a trust's liability will be ignored or reduced for the calculation of the principal charge on the trust's relevant property.

THE IMPACT OF THE CHANGES

The government has stated that it does not anticipate that these changes will have a significant impact on tax revenues. However the changes will have wide-ranging implications since there will be many individuals who have arranged their affairs with an eye towards IHT efficiency.

The changes also come at a time when changes to the taxation of companies holding high value property (Annual Tax on Enveloped Dwellings) mean many individuals were considering extracting property from the company along with the use of debt to reduce exposure to inheritance tax.

The following examples give an indication of the impact of the proposed changes.

Trustees of trusts settled by a non-UK domiciliary are recommended to review the situs of the assets within the trust 6 – 12 months ahead of any principal charges. Liabilities within the trust will be ignored for calculating the principal charge.

Non-UK domiciled individuals who have previously acquired UK property with a secured debt should seek advice as to the potential inheritance tax exposure under the new rules.

UK domiciled individuals who have taken on debt and invested in IHT-favoured assets (e.g. woodlands, or agricultural property) to reduce the value of their estate liable to IHT should review their tax affairs in light of these changes.

- Individuals who have borrowed funds from an employee benefit trust (EBT) should also consider the impact of these changes.
- Individuals with existing debts (which may be eligible for a deduction) but who intend to refinance should review whether a deduction will be available in future.

CONCLUSIONS

The economic reasons for taking on debt will not deter individuals from continuing to use debt finance. Those who are concerned about any additional potential exposure to IHT may opt for alternative solutions. This may have the consequence that the attractiveness of life assurance increases, while the appetite for other IHT-favoured investments decreases.

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