INHERITANCE TAX & BUSINESS PROPERTY: IT'S YOUR CHOICE !

Many shareholders and business owners are under the reasonable but erroneous impression that they do not need to think too deeply about inheritance tax because their company or business will be fully covered by Inheritance Tax Business Property Relief. This relief exempts shares in qualifying companies and business from Inheritance Tax on their death.

And many of them are right…. in principle anyway.

However, the vast majority of company and business owners will be very surprised to realise that there are usually potential Inheritance Tax problems lying just beneath the surface and which may not come to light until after they have passed away. By that stage there will be very few opportunities to put things right. Leaving an unanticipated tax bill of 40% of the value of affected business assets is not the sort of legacy the family, and successors to the business, will relish. Indeed, the requirement to settle the tax within 6 months of you dying could cause cash flow problems.

HM Revenue & Customs will, given that the 100% Business Property Relief is so valuable, go through your last 3 years accounts with a fine tooth comb to disqualify you from the relief where there is any chance of them doing so …. and in many cases they will succeed simply because it has all been left to chance.

All tax reliefs must be earned. That is because there are always stringent conditions which must be met to qualify for them. This relief is a complex one and there are many hurdles to overcome and traps to avoid falling into. It is equally true that very few businesses which do qualify really capitalise on the tax saving opportunities open to them as a result – with the right planning, for instance, even investments can be sheltered from inheritance tax using this relief. The result of leaving it to chance is often at least tens or hundreds of thousands of pounds or even more in unnecessary tax.

Most businesses start life as qualifying trading businesses or companies for inheritance tax purposes. In the early days of an entrepreneur's career avoiding Inheritance Tax is unlikely to be of any concern at all. The problems come later as the business grows and acquires value, so regularly reviewing matters is something which should always be on the agenda of established or mature family businesses.

There are many, many threats to consider as well as planning strategies which can very much operate in a traders, and their families, favour once a business is established. Passively doing nothing is certainly not one of them. That is a strategy which can only benefit HM Revenue & Customs over your family.

To take just a couple of hypothetical scenario's by way of illustration … hypothetical but based on actual cases and commonly encountered one's at that.

SCENARIO 1: A SUCCESFUL BUSINESS & ROLLED UP PROFITS

Ms A had built up a strong and viable business over many years. She let the profits roll up in the company bank account because she didn't want to pay the higher income tax rate that extracting the profits would entail and, in any event, didn't require the cash for personal expenditure. The cash balances, which totalled around £1 million, also improved the company annual accounts which in turn helped considerably with trading partners who felt confidence in dealing with her company. The balance sheet position was healthy and visibly so.

Unfortunately, Ms A passed away without undertaking any inheritance tax planning.

When her executors submitted the Inheritance Tax Account six months later, HM Revenue & Customs asked them to pay inheritance tax on the £1 million bank balance that Ms A had happily let build up in the company.

The executors and Ms A's family thought that the entire value of the company should be free from Inheritance Tax since the company was clearly trading, a reality which HM Revenue & Customs acknowledged. Unfortunately, the Inheritance tax rules maintain that if a company holds assets, including cash, that are not used in the company's trade, that proportion of the company’s shares are subject to inheritance tax whatever its trading status. Vague allusions to the cash being needed for future business activities met with little response from HM Revenue & Customs who were quite understandably prepared to litigate on the basis of the facts. The mistaken perception cost the family £400,000 in Inheritance Tax. A poor legacy.

The tragedy is that with a properly thought through medium-term strategy in place, it would have been possible to claim business property relief on some if not most of the cash. Leaving it until the last moment meant that the executors were prevented from effectively resisting HM Revenue & Customs arguments from a well-established position of strength.

SCENARIO 2: A SUCCESSFUL BUSINESS & PROPERTY INVESTMENT

Turning to another commonly encountered situation, where you own 100% of the business premises and more than half the company shares, you will nevertheless only get 50% business property relief on the business premises. So you only avoid inheritance tax on half the value. If you control less than half of the company, and you own the business premises personally, you may not get business property relief at all.

An issue to reflect on in itself but does this mean that holding your commercial property in your company a better option with respect to Inheritance Tax ? Not necessarily !

Imagine a successful businessman, Mr B, who builds up two separate, successful companies, with one company being owned by the other and Mr B owning the much larger top company – both represent trading companies and both meet the myriad of requirements to ensure that is the case. Mr B eventually sells the business in the top company and the buyer offered him an excellent price for the trade and assets. This left a substantial amount of cash in the larger top company. As a pragmatist, Mr B decided that the money had to earn its keep and invested the proceeds in a property portfolio. His smaller subsidiary company continued trading as it had always done from the company commercial property.

Mr B died unexpectedly and inheritance tax was payable at 40% on the full value of both companies.

On reflection it was perhaps easy for the executors to understand that the Government only wants to give tax relief on genuine business activities; letting property is a bit more like an investment, so perhaps that makes sense. But Mr B’s trading company was also subject to inheritance tax. Mr B’s family thought that this was unfair.

The problem here was that because the larger commercial property company owned the smaller trading company, that meant that the whole group was disqualified under the tax rules from claiming business property relief.

A similar outcome would also occur where a single trading company re-invested its surplus cash in, say, a property portfolio which ultimately grew to represent a major part of the business. A very common situation because in isolation it makes excellent commercial sense.

Under different circumstances, a holding company containing investments including holdings in trading companies might have qualified for the 100% relief in full provided that the holding company business consisted wholly or mainly in being a holding company of a trading company (or companies). In any event, a restructuring of the group would undoubtedly have saved considerable sums of inheritance tax for Mr B's family.

WHAT TO DO ?

HM Revenue & Customs are certainly going to review your accounts and circumstances as soon as Business Property Relief is claimed by your executors. There are no exceptions. Your executors will need to accurately report on your business to obtain Probate and as part of the overall Inheritance Tax Return and payment of tax. So the pressure is on immediately you depart this world. It is a pressure which comes at the worst of all times for the family.

The obvious step is to undertake exactly the same review of those accounts NOW and while you are in a position to do something about it.

If you are concerned about Inheritance Tax then it should be an essential element of business risk management that your business interests pass tax efficiently to those you wish them to and that any weaknesses to obtaining maximum Business Property Relief are addressed in your lifetime.

This article was originally written by Stephen Parnham for the Professional Panel