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LIFE INSURANCE SPECIALISTS

IHT planning: an outline

Synopsis: Background to planning, disclosure of tax avoidance schemes, powers of attorney and validity of gifts for IHT purposes.

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For most individuals, inheritance tax (IHT) planning will not be an end in itself, but a component part of an estate preservation exercise.

As such, any planning will have to take into account not only IHT mitigation, but also ensure, as the primary objective, the financial well-being of the individual concerned, their family and others they wish to benefit, together with the impact of capital gains tax (CGT), if any, on any lifetime gifts that may be contemplated as part of the estate planning strategy.

A starting point, for much estate planning, is to ensure that the client's Will is up to date and tax efficient. Advice may well also extend into areas such as lasting powers of attorney and, if estate preservation is the objective, the effects of the client requiring long term care in future should not be overlooked. Careful IHT planning strategies may come to nought if a client's assets are swallowed up by care fees.

A realistic approach to IHT planning focuses on planning with particular types of assets - for example, cash and investments, property in the form of land and buildings and business interests.

For those with available cash and investments, there are many packaged plans available that (predominantly) make use of insurance products combined with trusts.

With increases in the values of residential property, IHT has increased in importance as a source of revenue for the Exchequer. As a result, HMRC is taking a keen interest in much of the planning that is carried out and has challenged the effectiveness of a number of schemes.

The 2004 Finance Act contained the Pre-Owned Asset Tax (POAT) provisions which impose an income tax charge on donors who have made lifetime gifts of substantial assets with a view to avoiding IHT on such assets, but who continue to enjoy the assets after the gift without paying to do so.

In addition, in 2020, an all-party parliamentary group (APPG) of MPs recommended that all the existing lifetime gift exemptions, such as small gifts and normal expenditure, should be scrapped and replaced by a single annual gifts allowance, which the APPG suggested would be set at £30,000. In July 2019, the Office of Tax Simplification (OTS) also produced a report on the simplification of IHT in which they proposed a figure of £25,000.

No such changes have been announced to date. However, clients that can afford to make substantial gifts out of income may like to get that planning up and running

sooner rather later in case any rule change occurs in future – in the hope that if a rule change does occur, existing arrangements will be protected.

Disclosure of tax avoidance schemes

In the Autumn of 2010, HMRC announced that the Disclosure of Tax Avoidance Schemes (DOTAS) regulations were to be extended to certain IHT planning arrangements.

The DOTAS Regulations are an important weapon available to HMRC in its fight against tax avoidance schemes. In essence, if a scheme satisfies certain conditions, any person involved in the promotion of the scheme must disclose details of the scheme to HMRC. If they do not comply with this requirement, they risk suffering substantial penalties.

The Inheritance Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2011 were brought into effect to deal with this. These regulations were then superseded by the Inheritance Tax Avoidance Schemes (Prescribed Descriptions of Arrangements Regulations) 2016 which significantly broadened the existing IHT hallmark to a wider range of arrangements the main purpose of which is to enable a person to obtain an IHT advantage. Further regulations, The Inheritance Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2017, came into force on 1 April 2018, also replacing the 2011 regulations.

A scheme will be notifiable for IHT purposes *'if it would be reasonable to expect an informed observer (having studied the arrangements and having regard to all relevant circumstances) to conclude that conditions 1 and 2 are met'*. Note that an 'informed observer' is not an expert or a tax practitioner.

Condition 1 is that the main purpose, or one of the main purposes, of the arrangement is to enable a person to obtain one or more of the following IHT advantages...

- The avoidance or reduction of an entry charge on a relevant property trust.
- The avoidance or a reduction in specified IHT charges under certain sections of the IHT Act 1984 (mainly relating to relevant property trusts).
- The avoidance or a reduction in an IHT charge under the gift with reservation rules (in cases where the POAT charge does not apply).
- A reduction in a person's taxable estate with no corresponding lifetime transfer.

Condition 2 is that the arrangements involve one or more contrived or abnormal steps without which the tax advantage could not be obtained.

HMRC states that the use of trusts is not in itself contrived and making a loan to a trust would also not be abnormal to an 'informed observer'. In addition, HMRC has

provided a range of examples of arrangements which are not notifiable. And an established practice exception means that IHT planning that has already been implemented by, and is 'substantially the same as', arrangements that were entered into before 1 April 2018, and which at the time 'accorded with established practice of which HMRC had indicated their acceptance' is not notifiable under the DOTAS.

The intention is that any established IHT planning schemes whose workings are well understood and agreed will not be notifiable..

Powers of attorney and gifts

A question that seems to frequently arise is whether an attorney acting under a power of attorney is entitled to make gifts on behalf of the donor, especially with a view to mitigating IHT.

The general principle, which is similar in England and Wales and Scotland, is that an attorney has no power to make gifts, unless specifically authorised to do so. Powers of attorney are subject to a different law in Scotland.

Under English law, it is possible to have an ordinary power of attorney (general or specific) or a lasting power of attorney (LPA) - previously an enduring power of attorney (EPA). An ordinary power might be made to allow the attorney to carry out certain financial transactions on behalf of the donor, e.g. during the donor´s absence from the country or during a period of physical incapability and will terminate in the event of the donor becoming mentally incapable or dying. Both LPAs and their predecessors, EPAs, continue despite the onset of mental incapacity, however there are some differences.

LPAs must be registered with the Court from the point at which they are to be used, regardless of the individual's capacity and cannot be used before registration. An EPA does not need to be registered with the Court of Protection unless, or until, the individual who created it loses mental capacity.

Both LPAs and EPAs limit the attorney's power to make gifts to those that the donor would customarily or habitually make, say, on the occasion of Christmas or birthdays or to a charity.

Of course, while the donor is still mentally capable, there is nothing to stop the donor making any transaction that they wish, including making any gifts that they want to make themselves.

However, once mental capacity has been lost, gifts can only be made by an attorney who has secured the agreement of the Court of Protection.

There is a procedure set out in the guidance from the Court of Protection, standard application forms and a set of fees. Please see here. There is a fee of £371 payable on making an application to start proceedings.

Fees do change from time to time and the Office of the Public Guardian website contains up to date information on fees charged by the Court of Protection.

If a settlement, a deed of variation, a deed of family arrangement or similar deed is proposed, a draft of the deed to be executed should be sent to the Court of Protection with a spare copy in case amendment is required. Interestingly, the Court of Protection guidelines specifically mention that settlements in this context include those under insurance "inheritance trusts" and similar schemes. The fees for this type of transaction are the same as mentioned above.

With any application, the Court of Protection will consider the circumstances of the donor and will not consent to any gift if it would prejudice the financial circumstances of the donor. Particular attention is paid to any proposed gift of a private residence, where there is a possibility of the need for assistance from the local authority with any nursing home fees.

Also note that an attorney or receiver should apply to the Court of Protection to execute a statutory Will or codicil. A statutory Will is one which is executed by an attorney or receiver on behalf of an incapable person. There is a special form of statutory Will for patients which can be obtained from the Court of Protection.

What happens if an attorney purports to make gifts which they are not authorised to make?

Of course, if the donor is still mentally capable, they could subsequently ratify any such transaction. However, if the donor is no longer capable, legally, the gifts will be treated as void. This could have severe consequences on the death of the donor where the unauthorised gifts will be treated as being in the estate of the deceased.

For practical purposes, if the beneficiaries of the Will or intestacy were not the donees of the gift, they would be likely to demand a return of the gift. The most important aspect would be IHT as the gifted assets would continue to be subject to IHT in the estate of the deceased donor.

This was confirmed in the case of McDowall and Others (McDowall´s Executors) -v- IRC (SBC382) decided in June 2003. This was a Scottish case which concerned transactions that took place before the Adults Incapacity (Scotland) Act 2000 came into force. Mr McDowall´s attorney made several gifts although the power of attorney under which he acted included no specific power to make gifts. After Mr McDowall´s death HMRC contended that the gifts were not deductible from Mr McDowall´s estate for IHT purposes.

Although the executors appealed, the Special Commissioners dismissed the appeal, on the grounds that the attorney had no power to make the gifts and therefore the executors had the right to recover them.

Even though this was a Scottish power of attorney, the principle, as far as IHT is concerned, would be exactly the same in England and Wales.

Looking at the facts of another case, Day & others v Royal College of Music & Harris [2013], it was found that the attorney did in fact have power to make gifts in the same manner as he had prior to the registration once the power had been registered.

In this case, Mr Day had been granted an enduring power of attorney (EPA) in respect of Sir Malcolm Arnold (for whom he had cared for 22 years) in 1990. The power was registered with the Court of Protection in February 2002 following Sir Malcolm becoming mentally incapacitated.

While Sir Malcolm was still alive, a number of payments (totalling £36,000), expressed to be gifts, were made to Mr Day from a joint bank account in the names of Mr Day and Sir Malcolm Arnold, but in which Sir Malcolm Arnold was entitled to the money. Mr Day was a signatory on the account and, in accordance with a bank mandate, was able to draw cheques.

The payments were made in light of tax advice and had the effect of reducing Sir Malcolm Arnold's tax liability.

Sir Malcolm's two children sought an order that Mr Day should account to the Estate for those monies. They contended that (i) Mr Day was unable to make the gifts to himself as he held the EPA and (ii) in the alternative, the making of those gifts amounted to a breach of his fiduciary duties (owed as a result of the EPA).

In relation to this second point, a further issue arose as to the relevance and nature of any consent Sir Malcolm Arnold may have given.

Section 3 of the Enduring Powers of Attorney Act 1985 confers a general authority on the attorney on the donor's behalf. However, it was agreed that the payments at issue were not within the scope of section 3 and as such could not be justified under the EPA itself. The issue for consideration, then, was whether the attorney was able to make the gifts in their other capacity (i.e. acting under the bank mandate) and relying on the consent of the donor (notwithstanding the prior registration of the EPA).

On this point, the Judge found that it remained open to Mr Day to draw cheques on the account after the registration (with the free and informed consent of Sir Malcolm Arnold) in the same manner as he had prior to the registration and that the monies had been given to Mr Day by Sir Arnold with his free and fully informed consent given before the power was registered.

This decision is of particular interest as, in effect, the majority declined to find that an individual could be de facto deprived of their power to consent in all contexts by reason of a statutory mechanism (in this case the registration of an EPA).

Powers of attorney are becoming more popular and, typically, any solicitor advising on making a Will would also advise an individual to make a lasting power of attorney. It is essential that individuals and advisers advising on any financial matters are fully aware of what an attorney can and cannot do.