The Background to the Extension of the Disclosure Rules to Inheritance Tax Part 1

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In the first of a two-part article, Simon McKie examines the extension of the Disclosure of Tax Avoidance Schemes rules to certain arrangements conferring inheritance tax advantages. Those providing any sort of advice on inheritance tax should be aware that the extension imposes onerous compliance obligations on advisers which are enforced by draconian penalties.

The Disclosure of Tax Avoidance Schemes Regime (referred to herein as DOTAS or the Disclosure Rules) requiring disclosure of tax planning transactions,[1] has been extended, with effect from April 6, 2011, to certain classes of arrangement under which an advantage is obtained in relation to an inheritance tax charge. Large numbers of solicitors and other advisers who give advice on what might seem very routine inheritance tax planning to whom the Disclosure Rules did not previously apply, will now have to consider whether they have a duty to make a return under those Rules.

The decision to extend the Disclosure Rules to IHT

Ignoring expert opinion

The extension of the Disclosure Rules to inheritance tax lacked any proper assessment and quantification of its advantages and disadvantages. A Consultation Document proposing the extension was issued on July 27, 2010.[2] That referred to "some informal discussions [which] were held with representative bodies and other interested parties in January 2010" and asserted that the principle of extending the DOTAS regime "was generally accepted though there were concerns about how this might be implemented".[3]

In the Chartered Institute of Taxation's response to the Consultation Document, however,[4] it made the following comments which it described as "fundamental reservations":

> "1.2 We suggest that a review of the overall policy of inheritance tax (IHT) and what it is trying to achieve would be a better way of dealing with perceived tax avoidance than imposing yet another layer of anti-avoidance legislation in the form of these disclosure requirements. …

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1 Finance Act 2004 Pt VII. All further statutory references in this article are to Finance Act 2004 unless otherwise stated.
2 Referred to in the remainder of this article as the "Consultation Document".
3 Consultation Document para.3.3.
4 "Disclosure of Inheritance Tax Avoidance", response by the Chartered Institute of Taxation October 22, 2010.

2.1 **Misguided legislation**

> We have yet to be convinced that there is widespread avoidance of the IHT charge that arises when property is transferred into trust … The gift into trust provisions should be subjected to a policy review before the imposition of DOTAS system can be justified. … The cost assumptions provided in the Impact Assessment lack credibility."

In a similar vein, the Society of Trust and Estate Practitioners responded:

> "We would suggest that DOTAS represents a fundamentally flawed response to the real issue that arose out of a misconceived inheritance tax policy introduced in 2006. …
>
> We are concerned that, given the breadth of the draft regulation, much time and effort will be expended by … practitioners [who are not greatly concerned with sophisticated tax planning] … (giving rise to increased costs to their clients) establishing whether or not the strategy they are advising needs to be reported or not."[5]

HMRC published a summary of the responses to the consultation on December 6, 2010 in which these fundamental criticisms by two professional bodies, who between them represent the combined expertise of over 30,000 taxation and trust practitioners were dismissed as, "[t]wo respondents [who] felt that the proposed legislation is 'misguided' and a 'fundamentally flawed' response to what they perceive as misconceived policy changes in 2006".[6] The document went on to ignore these criticisms on the basis that they were "… beyond the scope of this consultation" there being "no plans for such a reform of IHT at this stage".[7]

A failure to accurately assess its financial impact

When the Regulations were laid before the House of Commons, they were accompanied by a Tax Information and Impact Note (TIAN) that revealed that the introduction of the scheme was not forecast to have any effect on Government revenues and yet which stated that "the change is expected to reduce the future use of IHT avoidance schemes [sic], which currently present a risk to the Exchequer." So either the use of such arrangements does not reduce overall Government revenues or the effects of the Disclosure Rules are so minor or so unpredictable that they cannot be taken into account in Government forecasting.

The TIAN had been preceded by an "Impact Assessment" (the RIA) which had estimated the administrative burden on "promoters" at £90,000 per year. This was based on a cost of each notification of £3,700 per scheme on the assumption that 25 schemes will be notified to HMRC in each year. The RIA said:

> "Many promoters are likely to be familiar with the DOTAS regime already as it applies to other taxes. Those likely to promote IHT schemes will also be familiar with the IHT regime and have processes in place to comply with the new rules. However [sic] there may be a few promoters who have no experience of the DOTAS regime. They would have to familiarise themselves with the regime and draft guidance for their staff."[8]

The use of the word "promoter" is misleading. It is a term used in the legislation where it is given a special meaning[9] very different from the meaning it bears in ordinary English usage. Any firm or individual advising on inheritance tax planning which includes property becoming relevant property may be a

[5] STEP Response to the Consultation Document issued on July 27, 2010 made on October 25, 2010.
[6] "Disclosure of Inheritance tax Avoidance: Summary of Responses", December 6, 2010.
[7] "Disclosure of Inheritance tax Avoidance: Summary of Responses", December 6, 2010 Section 2..
[8] Page 5 ibid.
[9] "*Impact Assessment of Disclosure of Inheritance Tax Avoidance*" July 22, 2010 p. 5.

promoter under the Disclosure Rules and will have to review their advice to see whether or not it must be disclosed. Many solicitors and financial advisers will have to consider the Disclosure Rules for the first time. Indeed in its summary of responses to the consultation document, HMRC admitted as much saying:

> "… in relation to IHT there is likely to be a higher proportion of lawyers among tax practitioners than may be the case for many other taxes. These practitioners may not have had to deal with DOTAS previously."

Prudent firms will institute a general procedure of reviewing all of their advice and that will impose costs on clients hugely in excess of £90,000 per annum.

The TIAN did take some account of the professional bodies' criticisms. It said for example:

> "on the basis of representative body estimates that up to 10,000 practitioners will need three hours training, … [initial costs] … will be in the region of £3 million.[10] Although not directly chargeable on individuals, these initial costs will ultimately influence fee charging policies."[11]

Having acknowledged that this new burden would be imposed by the change, however, the TIAN made no attempt to make any use of this assessment in its quantification of the cost of the compliance regime. In making that quantification it maintained the method of the RIA in assuming that 25 schemes will be notified in a year, increased the estimated cost of each notification from £3,700 to £4,400 (without explaining how that figure is calculated) and arrived at an annual cost of £110,000.

The TIAN placed great weight on the fact that HMRC:

> "… is developing a list of existing schemes and arrangements that do not have to be reported which should reduce the number of unnecessary disclosures."

As we shall see, the list produced by HMRC is confused, imprecise, inaccurate and heavily caveated and is unlikely to be of any material use to a practitioner in deciding whether or not a disclosure should be made.

It is clear that the major cost for practitioners will not be that of making returns required under the Disclosure Rules but that of reviewing advice to determine whether or not a disclosure is required. If we assume, for example, that the 10,000 practitioners to which the TIAN refers give, on average, 10 pieces of advice per year[12] and spend one hour reviewing each piece of advice[13] and if we adopt the Revenue's assumption that the average charge out rate is £100 per hour that would give an annual cost which will ultimately be borne by the clients of the advisers, that is by taxpayers, of £10 million. So a regime, the benefits of which are so unpredictable that they have no effect on the Government's forecasts of its income, is likely to impose an annual cost on this body of taxpayers of £10 million.

The extension of the Disclosure Rules to IHT, therefore, cannot be justified on financial grounds. As STEP's representations made clear, the increase in IHT transactions undertaken for IHT planning purposes, if indeed there was such an increase, to which the new rules are claimed to be a response was merely a symptom of a more fundamental problem. That more fundamental problem is the conceptual incoherence of the rules governing the Inheritance taxation of trusts which resulted from the changes made in the Finance Act 2006.

[10] This implies an average charge out rate of £100. As the individuals being trained will need to fully understand the relevant IHT provisions and have the capacity to understand the complex Disclosure Rules that is unrealistically low.

[11] TIAN, "Impact on individuals and households".

[12] Surely a very modest estimate.

[13] Considering the complexity of the issues this is a very low estimate of the time involved.

The content of the new Disclosure Rules relating to inheritance tax

Arrangements: prescribed descriptions

The description of arrangements which fall within the Disclosure Rules is prescribed by the Treasury in Regulations. Each set of regulations prescribes one or more descriptions in respect of particular taxes. A description in respect of IHT is prescribed by, and only by, the Inheritance Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2011 (SI 2011/170) (the IHT Regulations).

Regulation 2[14]

Regulation 2(2) & (3) of the IHT Regulations provides:

> "(2) Arrangements are prescribed if—
> (a) as a result of any element of the arrangements property becomes relevant property; and
> (b) a main benefit of the arrangements is that an advantage is obtained in relation to a relevant property entry charge.
> (3) In this regulation—
> …
> 'relevant property' has the meaning given by section 58(1) of the Inheritance tax Act 1984;
> 'relevant property entry charge' means the charge to inheritance tax which arises on a transfer of value made by an individual during that individual's life as a result of which property becomes relevant property;
> …"

Because these arrangements are prescribed in relation to inheritance tax, arrangements will only be notifiable arrangements if they enable a person to obtain an advantage in relation to inheritance tax and not, for example, if property becomes relevant property for the purposes of inheritance tax and in so doing confers an income tax advantage.[15]

Any element of the arrangements

It will be seen that arrangements will not be prescribed unless "as a result of any element of the arrangements property becomes relevant property". What is an "element" of the arrangements? If I give property to my son and he in turn settles the property on trust for his daughter is the settlement a result of an element of the arrangements if:

a) at the time when I make up my mind to make the gift we plan together that my son should make the settlement;
b) we do not plan my son's settlement, but he is enabled to make the settlement by the gift because he has no other assets with which to do so,
c) we do not plan my son's settlement and he would have been able to make the settlement whether or not the gift proceeded but he feels morally obligated to share his good fortune with his daughter?

The answer is by no means clear. Tentatively, I should expect a court to find reg.2(2)(a) satisfied in relation to (a) and, possibly, (b) but not in respect of (c).

[14] All references to regulations in this article are to the IHT Regulations unless otherwise stated.
[15] Section 306(1)(b).

A relevant property entry charge

It can be seen that for the condition in reg.2(2)(b) to be satisfied the advantage must be obtained "in relation to a relevant property entry charge" and that "a relevant property entry charge" means "the charge to inheritance tax which arises on a transfer of value made by an individual during that individual's life as a result of which the property becomes relevant property." What is the effect of the opening indefinite article? It surely requires there to be an actual relevant property entry charge arising under the arrangements rather than merely referring to the abstract concept of the relevant property entry charge. So, under this construction, if no benefit is obtained in relation to an actual relevant property entry charge the arrangements will not be prescribed. So, if it were possible to place property in a relevant property settlement without giving rise to a relevant property entry charge, reg.2(2)(b) would not be satisfied even if there were an alternative way of achieving the same result under which such a charge would arise.

It does not appear that HMRC accept that this is the case.

Paragraph 9B.4.3 of the Guidance says:

> "Where there are:
> - arrangements which result in property becoming relevant property;
> - there is no transfer of value; but,
> - in the absence of other intervening steps in the arrangements there would have been a transfer of value;
>
> disclosure may be required. This is because the arrangements, have, by definition [sic], resulted in an advantage in respect of the relevant property entry charge."

Paragraph 9B.6.2 of the Guidance says under the heading "Examples of arrangements not exempted from disclosure":

> "Examples of arrangements which would *not* be excluded from disclosure include arrangements where property becomes relevant property and an advantage is obtained in respect of the relevant property entry charge:
> - where the claim that there is no transfer of value relies on a series of transactions where, in the absence of all other intervening steps, there would have been a transfer of value and a relevant property entry charge."[16]

So it seems that, in HMRC's view, a benefit may be obtained where no relevant property entry charge actually arises but one would have arisen had the same result been obtained by different transactions.

If that is HMRC's view, they are incorrect.

It may be that HMRC have reached this view because they have overlooked the significance of the indefinite article in reg.2(2)(b). In the passage quoted above from para.9B.4.3 and in the following passage from para.9B.4.1, for example, they substitute the definite for the indefinite article:

> "It is important to note that under the Regulations a scheme is only disclosable if there is a tax advantage in respect of *the* [Emphasis added] 'relevant property entry charge' (see 9B.4.2. below). Where a scheme provides a tax advantage but that advantage is not in respect of *the* [Emphasis added] 'relevant property entry charge' then disclosure will not be required under the Regulations."

[16] Guidance para.9B.6.2.

If they were correct in their view, however, it would not be necessary for arrangements to include a transfer of value for them to be notifiable arrangements. That is because, if that view were correct, it would be sufficient for property to have become relevant property as a result of the arrangements and that a relevant property entry charge would have arisen on alternative transactions even if one did not actually arise. The Guidance, however, says at para.9B.4.3.

> "Where there is no transfer of value and no wider arrangements then no advantage can be obtained in respect of a transaction which results in property becoming relevant property."

This article is based on a longer article which first appeared in the *Rudge Revenue Review*.