INHERITANCE TAX RELIEFS: EXPENSES AND LIABILITIES

Tolley®Guidance

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Expenses and liabilities

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General principles

Expenses and liabilities may reduce the value of property to be charged to inheritance tax. This general principle arises from the 'meaning of estate' given in IHTA 1984, s 5 which includes the provision:

In determining the value of a person's estate at any time his liabilities at that time shall be taken into account, except as otherwise provided by this Act.

Transfers of value are quantified with reference to the amount by which a person's estate has diminished. The transfer on death is equal to the value of the whole of a person's estate immediately before his death. It follows that the value of transfers is reduced by the associated liabilities.

IHTA 1984, ss 3-4

When considering settled property, inheritance tax is charged with reference to the 'value of the property or part at that time.'

IHTA 1984, s 64(1)

The value of any property for inheritance tax purposes is 'market value.' The market value of assets is reduced by liabilities.

IHTA 1984 s 160

The practical application of these general principles to the valuation of property for IHT means that, for example:

•the value of a death estate is reduced by the deceased's outstanding personal debts such as household bills and credit cards

•the value of a gift - such as a house - is reduced by liabilities attached to it - such as a mortgage

•the value of settled property is reduced by the trustee's outstanding debts such as professional fees

See Example 1, which also illustrates some of the principles described below.

Specific provisions

The general principles are qualified and expanded by a number of specific legislative provisions.

Liability must be legally enforceable

A liability is allowed only if:

IHTA 1984, s 5(5)

•it is imposed by law, or

•it was incurred for consideration in money or money's worth.

So where the taxpayer has a contractual debt, such as an electricity bill, or he has not yet paid for goods or services received, the liability is allowable. The position is more difficult with a voluntary payment such as the promise of a gift, or an oral agreement for an informal loan. It is not allowable if it is not legally enforceable.

•divorce and separation payments which are outstanding at the date of death may be deducted if they are paid under court order or agreement by Deed (IHTM28090)

•an informal loan may be recognised as a liability in the estate if it can be established that there was an agreement to repay the amount. Ideally the agreement should be in writing, but an oral agreement will suffice if other evidence, such as repayments being made before death, is available. (IHTM28323)

•payment by cheque is not effective until the cheque is cleared by the bank. Uncleared cheques that appear on the bank statement after the date of death may be deducted only if they represent legally enforceable liabilities. See Example 2. (IHTM28300)

The value of the liability

For liabilities which are payable in full on the chargeable date, or where they arise in connection with normal commercial transactions entered into before the date of death or transfer, the full amount payable is taken into account. Occasionally, a liability is not due to be paid until a date in the future in which case the value is discounted at a commercial rate of interest.

IHTA1984, s 162(2)

If there is a right to full or partial reimbursement for the liability, it must be valued taking account of the amount likely to be received.

IHTA 1984, s 162(1)

Transferor's expenses

Expenses incurred in making a lifetime transfer may include transport charges, legal costs and insurance. If they are paid by the transferor, the taxable value of the property transferred is not increased by the expenses (even though the loss to the donor is increased). If they are paid by the transferee, they reduce the taxable value of the property received.

IHTA 1984, s 164

Funeral expenses

The value chargeable on death is taken to be the value of a person's estate immediately before he died. It does not include a deduction for the expenses of administering the estate. There is a statutory exception for 'reasonable funeral expenses'. By HMRC practice these include:

•the funeral directors' account

•the personal representatives' expenses in arranging the funeral

•funeral flowers

•a gravestone

•funeral reception

•repatriation and embalming costs where the deceased's body is to be transported to or from the UK

IHTA 1984, s 172

Note also that where the deceased is non-UK domiciled, and the funeral is held abroad, a deduction for funeral expenses against the UK estate is still allowed.

IHTM10376

Other mourning costs may be allowed where they are appropriate to the size of the estate and the custom of the deceased's family. Where personal representatives wish to claim a significant and unusual expense, they should provide details on the IHT 400.

Expenses incurred abroad

There is another statutory exception for expenses incurred after death relating to overseas property. Where the deceased owned property outside the UK, a deduction is allowed for the expense of administering or realising the property. The allowance is limited to expenses attributable to the situation of the property, and not exceeding 5% of its value.

IHTA 1984, s 173

Matching liabilities with assets

The general rule when valuing a whole estate or collection of assets is that total liabilities are deducted from the total of assets.

HMRC's view is that excess liabilities in one component, such as the free estate, cannot be deducted from the value of assets in another, such as jointly owned or settled property, but it accepts that a contrary view may be argued.

IHTM28397

The general rule is modified by some statutory provisions:

•where a liability is charged on a specific property, it reduces the value of that property. If the liability exceeds the value of the property on which it is secured, the excess is deducted from the general estate. (IHTA 1984, s 162(4))

•where a liability is to be paid outside the UK to a person who is not resident in the UK, it reduces the value of property outside the UK, unless it is secured on property in the UK. Again, excess liabilities in this category are deducted from the general estate. (IHTA 1984, s 162(5))

•liabilities incurred for the purposes of a business reduce the value of the business (IHTA 1984, s 110)

Clearly, these provisions can affect the tax liability attributable to separate assets within the estate. They can also have an effect on the total tax payable. For example:

•where a mortgage is charged on exempt property left to the spouse or civil partner, it cannot reduce the chargeable estate

•where a loan is secured on property eligible for the instalment option, the share of tax payable by instalments will be reduced with a corresponding increase in the share of tax payable immediately

•liabilities payable to a foreign creditor are not deducted against the UK estate, unless they are secured on UK property. This increases the total tax liability for a non-UK domiciled individual who is only liable for IHT on UK situs assets.

Finance Act 2013: additional provisions on the treatment of liabilities.

Finance Act 2013 introduced further limitations on the matching of liabilities with assets. They apply to transfers of value made on or after 17 July 2013, the date on which the Act received Royal Assent. In summary they are:

•where a liability is attributable to financing the acquisition or maintenance of excluded property, it is to be matched with that property (IHTA 1984 s 162A)

•where a liability is attributable to financing the acquisition or maintenance of property which qualifies for Business Property Relief (BPR), Agricultural Property Relief or Woodlands Relief, it is to be matched with that property (IHTA 1984 s 162B)

•a liability may reduce the value of a person's estate on death only if it is paid out of the estate in money or money's worth (IHTA 1984 s 175A)

The effect of the first two provisions is to ensure that where loans have been taken out to finance the purchase of exempt or relieved property, the liability must be deducted from the value of the assets qualifying for relief, which means, that no tax will be saved because the assets are already relieved. This overrides the requirement to match a liability with the asset on which it is secured. In the case of excluded property, the limitation applies to any liability existing at the date of transfer, no matter when it was incurred. For relievable property, it applies only to liabilities incurred on or after 6 April 2013.

The deduction of expenses and liabilities from excluded property is illustrated in Examples 3, 4 and 5 accompanying the Excluded property and situs of assets guidance note.

The effect of the provisions relating to property which qualifies for BPR is illustrated in the BPR and debt guidance note.

The third new provision on death estate liabilities is aimed at arrangements where a deduction in a death estate is claimed, but in the event the liability is never paid. It excludes genuine commercial reasons for not paying the debt. The rule is not intended to place restrictions on the timing and nature of payment of a genuine debt. Where, for example, a beneficiary assumes responsibility for payment of the debt out of his inheritance, it will not be disallowed provided it is paid. It is rather intended to catch artificial arrangements for reducing the value of the estate on death. See Example 3.

Avoidance Schemes

Some of the tax arrangements targeted by these new measures include:

•Schemes involving AIM listed investments

Some financial advisers promote IHT 'solutions' involving the acquisition of a portfolio of shares that qualify for BPR after two years. The investment is financed by securing a loan on the home or other chargeable assets. Under the new rules, the value of the chargeable assets will not be reduced.

•Transferring value offshore

A non-UK domiciled person may obtain a loan secured on UK assets and invest the cash overseas, thereby reducing exposure to inheritance tax on the UK property. The new provisions will attach the loan to the excluded property.

•De-enveloping

The new taxes on high value residential property held by companies are encouraging the extraction of UK property from the corporate envelope. The property then becomes subject to UK inheritance tax, but arrangements have been devised to make 'de-enveloping' more attractive by reducing the value of the property with a debt secured against it. The proposals on liabilities mean that arrangements that transfer the value of the loan to excluded or relieved property will be ineffective.

•Loans from employee benefit trusts

The disguised remuneration provisions prevent the creation of notional loans to remunerate employees. Nevertheless, loans which pre-date those provisions may remain outstanding. In most cases, it is not intended that the loan will be repaid but if it is written off it will be subject to an income tax charge. The new IHT provision for the discharge of liabilities after death will prevent an outstanding loan from reducing the death estate if it is not repaid.

Tax liabilities

Tax liabilities which arise before the date of death or other occasion of charge are taken into account in valuing the property to be charged to inheritance tax.

If one chargeable transfer follows another (for example if a deceased person made a chargeable lifetime transfer just before he died), the inheritance tax due on the first transfer will reduce the value of the estate chargeable on the second transfer. The full amount of the liability is included even though it may not be payable until a date in the future.

IHTA 1984, s 162(3)

Income tax and capital gains tax liabilities arising up to the date of death are deducted from the value of the chargeable estate for inheritance tax purposes. In contrast to inheritance tax liabilities, there is no statutory provision to charge the full amount of the liability where it is not immediately due. In practice the amounts are usually small in relation to the value of a death estate and the full amount is deducted. However, it should be noted that HMRC may argue that the liability should be discounted where it is significant and arises some time before the payable date. For example, a large capital gains tax liability arising in April will not be due until 21 months later.

In addition to liabilities arising before the chargeable date, there is relief for those which arise simultaneously as a result of the transfer of value.

Where a chargeable transfer involves a disposal on which a capital gain arises, the capital gains tax is deducted from the value of the transfer if borne by the transferee. In other words, it is treated in the same way as transferor's expenses (see above). This situation will not arise with the inheritance tax charge on death because of the 'tax free uplift on death' for capital gains tax purposes. It may arise on a chargeable lifetime transfer, and will apply to an inheritance tax exit charge on relevant property where a beneficiary becomes absolutely entitled to trust assets.

IHTA 1984, s 165; TCGA 1992, s 62

The legislation also provides specifically for a deduction of income tax arising on offshore income gains and deeply discounted securities when a disposal is deemed to occur on death.

IHTA 1984, s 174

Claiming a deduction

For death estates, expenses and liabilities are claimed on the Inheritance Tax Account IHT400. Details of creditors, types of liabilities and amounts are to be listed on page 8.

Where the charge is on settled property, liabilities are to be listed on the main form IHT100 on pages 3 and 4 as appropriate.