Chattels: Inheritance Tax Mitigation

Someone who is serious about taking steps to ensure that as much as possible of their possessions goes to members of the family after their death, instead of to the Chancellor of the Exchequer, needs to beware of a particular trap. Detailed attention might be given to what might be called the 'major' family assets such as the home, business interests, stocks and shares and so on. The trap, however, is to overlook other assets which might have quite substantial value attached to them.

What are *'personal chattels'*?

Personal chattels are defined by statute, namely in the Administration of Estates Act 1925 section 55(1)(x) as amended, for deaths on and after 1 October 2014, by the Inheritance and Trustees' Powers Act 2014 as "all tangible movable property" except for property:

- Consisting of money or securities for money; or
- Used at the death solely or mainly for business purposes; or
- Held at the death solely as an investment.

This will include paintings, furniture, silver, jewellery and so on.

Such property may well have significant sentimental value and a person making a will (called the 'testator' or 'testatrix') might spend considerable time and effort in deciding to whom they should go under the will, if not the subject of prior life-time gifts. And indeed (a non-tax point) it is often a good idea to make that decision in some detail, so that those who survive, typically the children, will know what their parents' wishes were, which might help defuse the possibility of unseemly wrangling.

The monetary value of chattels can well amount to a tidy sum, resulting in a substantial Inheritance Tax (IHT) liability at 40% in the absence of an exempt gift to a surviving spouse/civil partner. So what can be done?

Wills: the Letter of Wishes

While on the subject of wills, particular chattels can of course be left to particular individuals. On the other hand, it is quite convenient and quite common for them to be covered by a 'sweep up' clause such as *'I give to my wife/husband my personal chattels as defined in the Administration of Estates Act 1925 section 55(1)(x) as amended by the Inheritance and Trustees' Powers Act section 3 and make the request but without imposing any binding trust or obligation that she/he gives effect to any letter of wishes which I leave regarding their distribution, within two years after my death'*.

To start with, the gift is of course spouse exempt from IHT. However, to the extent that the survivor does distribute the chattels in this way within two years after death, a specific provision in the legislation has the automatic effect that for IHT purposes the ultimate beneficiary is then regarded as the original donee under the will, so creating a chargeable transfer to that extent. That said, such a result may well be unhelpful now that we have the transferable nil-rate band as between

spouses/civil partners. Other things being equal, it is generally accepted that, on the first death of the married couple/civil partnership, the spouse exemption should be maximised, ideally to 100% of the estate. This has the effect of doubling up the nil-rate band on the second death, to particular advantage in the event of an increase in the nil-rate band threshold between the two deaths.

This statutory provision can therefore pose a trap. The survivor is unlikely to want to wait until after the expiry of the two years in order to make the distribution, which would then be a potentially exempt transfer (PET) by her/him, to become exempt on survival for seven years. Rather better, in the context of will drafting, is for all the chattels (perhaps along with other property) to go into an immediate post-death interest in possession trust for the survivor and have the trustees make the distribution which, however short a time after the death, does indeed cause the survivor to make a PET and is not written back into the Will.

Facing up to the value

It is essential to appreciate that the chargeable value on death for IHT purposes is 'market value'. This is defined as '*the price which the property might reasonably be expected to fetch if sold on the open market at that time…'*. In particular, the myth which has grown up in the past that a concessionary one third or so can be knocked off the market values of chattels for probate purposes is quite unwarranted. And indeed, in various publications put out by Her Majesty's Revenue and Customs (HMRC) since December 2004, HMRC have been specifically emphasising the importance both of including all the household and personal goods owned by the deceased and in valuing them on the proper statutory basis.

Moreover, this point is emphasised in the form which must be completed after a death to give the details of the chattels: Schedule IHT 407, the four sections of which deal separately with:

(a) jewellery
(b) vehicles, boats and aircraft
(c) antiques, works of art or collections and
(d) household and personal goods.

Individual items of jewellery valued at £500 or more must be detailed, together with a professional valuation if obtained. Indeed all items with a value of £500 or more should be valued professionally. If at the time of completing the Inheritance Tax Account any goods have already been sold, the gross sale proceeds must be recorded as assumed to be the value at death, with no deduction allowed for professional costs of sale.

It should be recognised that insurance valuations are not the same as market valuations. And so, at a time when one is thinking about IHT mitigation generally, it is a good idea to have up-to-date market valuations of all one's possessions, including personal chattels. Of course, certainly in the art world, valuations can fluctuate considerably from year to year. What will matter is the value at the date of death or chargeable lifetime gift.

The problem

So, supposing that the market valuation comes up with, maybe, £100,000, £200,000, £500,000 – or even more? In the absence of a surviving spouse and subject to an available nil-rate band, IHT at 40% will be payable. Of course the chattel or chattels concerned can always be sold to pay the tax, but if say the children want to retain them, they will have to find the money from elsewhere.

Lifetime gifts

A gift to say adult children (or indeed grandchildren) which the donor survives by seven years will be a PET which becomes exempt. Capital gains tax (CGT) must be borne in mind, as discussed below.

The donor should recognise that, unless he or she is content to part with the possession, an outright gift does introduce an element of vulnerability, which is that the donee might want to remove or even sell the chattel at any time – and it could also be taken in either bankruptcy or matrimonial proceedings. These risks could be removed by the use of a trust, suggested below for capital gains tax mitigation reasons.

The IHT problem arises in the case where both donor and donee want the donor to continue to enjoy possession. If possession continues without payment of *'full consideration in money or money's worth'*, there would be a reservation of benefit (GWR) by the donor, with the effect that on death the assets concerned will be treated for IHT purposes as remaining within the chargeable

estate – and with no impact on the CGT or indeed general law implications of having made the lifetime gift, ie specifically no CGT-free uplift to market value on death. And, in the event that some technical mechanism were used to avoid a GWR, there would likely be an annual Income Tax liability under the pre-owned assets (POA) regime, so that Income Tax would be payable at the 'official' rate of interest of the market value of the property enjoyed, which has decreased from 4% to 3.25% for 2014/15.

The CGT angle

A gift, just as much as a sale, constitutes a disposal for CGT purposes. The chargeable gain is worked out in the ordinary way, with the market value of the asset taking the place of the sale proceeds. There is a statutory exemption for gifts of chattels, but this applies only so long as the market value of the chattel or set of chattels does not exceed £6,000. If the value does exceed £6,000, deducted from any chargeable gain is so much of it (if any) as exceeds five thirds of the difference between the value of the chattel and £6,000.

Example

Bertie gives to his son an antique table worth £4,000 which he acquired three years ago for £1,000. The disposal is exempt, the value not exceeding £6,000. He also gives to his daughter a painting worth £20,000 which he inherited two years ago when worth £5,000. The gain is £15,000. Five-thirds of the difference between £20,000 and £6,000 is £23,333. But the gain does not exceed this and therefore the figure of £15,000 stands.

So, subject to the chattels exemption, the total of gains may well exceed the donor's annual exempt amount for the year, to the extent not otherwise used.

Of course it may be that a loss arises on any particular chattel. There is an anti-avoidance rule which provides that a loss on a disposal to a connected person (including relatives, such as here) can be set off only against a gain arising on a disposal to that same connected person. That could help in the present context. If for example a mother makes gifts to her daughter which (outside the chattels exemption) produce gains of £20,000 and losses of £5,000, that gives rise to net chargeable gains of £15,000.

What one might think about doing in the event of significant prospective CGT liabilities is making a gift of the chattels to a trust from which donor (and spouse) are excluded from benefit where the values do not exceed the available nil-rate band. Remember that the £325,000 threshold is reduced by any chargeable gifts made by the donor within the previous seven years. Given adoption of the licence arrangement described below, so that income would arise to the trustees, it is likely that the trust would be interest in possession in form, that is specific children would have the rights to the income on which the trustees would be liable to pay Income Tax at the basic rate at 20%. Whether the children would have to pay an additional 20% or 25% would depend on their other income. The important point is that, being a 'relevant property' trust for IHT purposes, it is possible for the donor to elect to 'hold over' the gain, so that the trustees would take on the donor's base cost of each chattel. The election must be made by formal notice within four years after the end of the tax year.

The chattels could in principle remain within the trust, though once they have been there for at least three months (and preferably for at least a year or so) the trustees could choose, with an eye on then values, to distribute assets piecemeal out of trust. This would trigger a CGT disposal, bearing in mind the trustees' reduced annual exemption (depending on the number of settlements made by that settlor, up to a maximum of five). Alternatively, they could elect with the beneficiary to hold over any gain.

Trustees also need to be aware of compliance requirements on each ten year anniversary of making the settlement. In particular, if just before the first ten year anniversary values had risen above the then nil-rate band, it would be possible under the current regime to disband the trust without paying IHT, while indeed holding over the gain, to be 'inherited' by the recipient beneficiary.

The licence arrangement

What follows is merely an outline of a structure which a number of taxpayers have adopted and which, if properly implemented, is in principle accepted by HMRC. The matter of 'proper implementation' cannot be stressed too highly. The GWR rules are very strict. Even if more than

seven years have elapsed since the date of gift so that the PET becomes exempt, any element of enjoyment for less than *'full consideration'* (beyond the '*de minimis*' let-out) brings the whole value of what has been given away back into the chargeable estate. The disaster scenario therefore (on the basis of what follows) is that a gift is made, full consideration is paid for the next 12 years (say), Income Tax is paid by the donee(s) and then in the following three months, just before which the donor dies, for some reason no fee is paid. The IHT planning which has been done is rendered completely ineffective. And indeed, supposing that the value of the chattels has increased since the date of gift, it is that higher value at the date of the death which is brought into charge.

The mechanism described below assumes that an effective gift has been made, typically evidenced by the documentation. There is no longer any Stamp Duty issue (as there was before 1985). The CGT implications are as discussed above. There is a small point presented by the Bills of Sale Act 1878, in the perhaps improbable circumstances that the donor becomes bankrupt, but the asset remains in the donor's possession. In that case the gift will be void as against the trustee in bankruptcy, unless it has been registered under the Bills of Sale Act 1878 (this involves a loss of confidentiality which is likely to prove unattractive, as the public can inspect the register). However, it is important to note that failure to observe the Bills of Sale Act 1878 does not make the gift void for IHT purposes and the point is mentioned here for completeness.

So the issue for both GWR and POA purposes is that continuing possession by the donor of the chattels given away will be ignored if the donor pays '*full consideration in money or money's worth'*. The problem is determining what is '*full consideration'*, especially in a case such as this where there is no obvious market place as there is with for example rented houses or flats. HMRC express the view in their Manual that the test will be satisfied if the terms of the deal are the result of a bargain negotiated at arm's length, with the parties being independently advised and following the normal commercial criteria in force at the time they are negotiated.

The nuts and bolts

Such independent advice may be thought to be not strictly necessary, in that following a death it would always be open to the personal representatives to produce evidence that the consideration paid had been *'full'*. However, this would inevitably attract close scrutiny from HMRC. It is much easier to have evidence of that independent advice and negotiation at the time. So independent third party auction houses or appropriately qualified valuers would be appointed, one acting for the donor licensee(s) and the other for the donee licensor(s). As with any licence (or lease) agreement, the amount payable would depend specifically on the terms of the agreement, in the sense that the greater the burdens on the donor licensee the lower the rent. Generally the donor would be required to insure the chattels at their full replacement value, noting the interests of the new owner(s). What would happen is that the agents for the new owner(s) would start off by proposing a rent which is then negotiated and finally agreed and put in the agreement. The agreement might run for say three years, following which there would be a renegotiation of the annual fee. The parties should be careful to ensure that the fee is actually paid each year and that it is recorded by the donee(s) on their tax return(s), with Income Tax paid.

Some years ago, HMRC were arguing that, to be *'full',* the level of consideration paid should be 5% of the market value of the chattels. This was then the 'official rate' of interest used to fix the taxable benefit of beneficial loans (and is specifically written into the POA legislation to quantify the taxable benefit of rent-free occupation of land or possession of chattels). That rate then went up, but most recently for 2014/15 has been reduced to 3.25%. However, this rate becomes irrelevant in the presence of a properly drawn agreement.

HMRC's views

This issue comes up from time to time in discussions between HMRC and professional advisers in what is called the Chattels Valuation Fiscal Forum which meets two or three times a year. It is recognised by all parties that to a large extent the exercise is a fiction, simply because there are no comparables in the real world to which regard can be given, as there are for houses and flats for example. The minutes of the latest meeting confirmed that approximately 1% of

the capital value was likely to be adequate consideration.

This figure assumes that the licensee pays the insurance and has responsibility for repair and maintenance. Following a death HMRC do ask to see the papers going back seven years and, in particular, evidence of negotiation. The December 2009 Forum minutes state that:

'Every case will be treated on its own merits, but if there is no meaningful rental market and the other advice set out in the minutes to the 2006 Forum is adhered to, then a rate of 1% is likely to be acceptable. How any Tribunal might treat the costs of ownership remains undecided, but thus far no insurmountable problems have arisen as those costs are usually a very small percentage of the capital value. The further the net rental rate drops below 1% the more likely it is that HMRC will mount a challenge. Purely nominal rental rates will most certainly be challenged. HMRC will not raise frivolous enquiries'.

Other options?

Other possibilities to mitigate IHT on chattels which the donor continues to enjoy might be explored, though are not considered here as being rather more recondite. The full consideration licence arrangement is reasonably 'tried and tested', though you should be warned that it will be considered by HMRC as tax planning and as such will be subject to careful investigation. As ever, both following the gift and indeed following the donor's death, full information should be given to HMRC.

Example

Anna, a widow, lives in the Old Rectory where she much enjoys a variety of furniture, paintings and silver left by her late husband Richard. But she is aware that, with values of around £500,000 in total, an IHT bill of up to £200,000 on her ultimate death (which should be at least 10 years hence) will prove unwelcome to her two sons whom she wants to inherit in due course.

So, on advice, Anna makes a Deed of Gift of specified chattels to each son, agreeing that, on the basis that she will pay the replacement value insurance and an arm's length licence fee (to be re-negotiated every three years), she will continue to house the chattels at the Old Rectory.

Negotiations are made between an auction house acting for Anna and a valuer for each of the two sons to arrive at an appropriate fee for each chattel or set of chattels. Anna pays the fee each year and her sons pay Income Tax thereon. A careful eye is had to CGT. Happily, none of the values or gains on the chattels is sufficient to produce a CGT bill, given Anna's annual exempt amount and some general brought-forward losses.

Conclusion: the merits of a chattels licence

Suppose that widowed Mother owns chattels worth £250,000, with prospectively an IHT liability on death of up to £100,000 at 40% and she is loathe to part with possession. There will obviously be costs of both the initial exercise and the three yearly revaluations. Assume that CGT can be avoided. Mother would pay an annual licence fee of around £2,500 on which, subject to the donees' other income not pushing them beyond the basic rate, Income Tax at 20% would be £500. Suppose Mother survives 10 years after making the gift. Assuming no appreciation in value £100,000 of IHT has been saved at a cost of the professional fees and a total of £5,000 of Income Tax. The main advantage of course is that all the chattels remain exactly where they have been, continuing to be enjoyed by Mother.

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