Revenue sets sights on IHT

Inheritance tax investigations by HMRC continue to increase. Waqar Shah and Anna Metadjer outline the current state of play

Inheritance tax liabilities for the tax year 2021 – 2022 were the highest ever recorded at £5.99 billion, as confirmed by annual statistics issued by HMRC on 31 July 2024. Given the sums involved, it is unsurprising that inheritance tax is a particular area of focus for HMRC investigations, which are reported to have resulted in recoveries of £1.39billion in underpayments of inheritance tax over the past five years.

It was confirmed further to a freedom of information request that HMRC opened 2,029 inheritance tax investigations between April and November 2023. This focus on inheritance tax investigations is not expected to change under the Labour government. It was announced by Chancellor of the Exchequer Rachel Reeves on 29 July 2024, that HMRC will be given greater resources to tackle tax non-compliance, with an aim of raising £5billion a year by the end of the decade through the recovery of unpaid tax.

Despite the large sums received by HMRC for inheritance tax, it is often forgotten that no tax is payable on the vast majority of estates in the UK due to them passing to a spouse (where there is a full exemption), or being valued at less than the current nil-rate band of £325,000. Indeed, even if the estate is valued in excess of £325,000, tax may not be payable depending on other reliefs available. For example, a main residence nil-rate band of £175,000 may be applicable if the estate is worth less than £2million and the deceased leaves their home to their children or grandchildren. As unused nil-rate bands can be shared between spouses, the total tax-free allowance may be up to £1million for a couple.

It is estimated that inheritance tax is currently only payable on circa 4% of estates, though this is expected to increase in the coming years as the value of estate assets exceed the nil-rate band. However, this is not just a tax that impacts the “wealthy”. Given that the value of property has increased dramatically over the decades, a family who may have purchased a property in the seventies, but otherwise does not have much by way of assets, could find themselves with significant inheritance tax to pay. This is most common in places like London and the South East of England, and can result in unfair outcomes, such as the children of the deceased needing to sell the family home in order to pay the inheritance tax due, and being unable to afford another property in the area, where they would otherwise have continued to live close to family and friends.

Responsibility for paying

Personal Representatives (PRs) are responsible for ensuring that the correct inheritance tax is paid on an estate.
Lay personal representatives may decide to deal with the administration of an estate themselves to save on professional costs, but despite past pushes for reforms, rules relating to inheritance tax remain complex. Failing to obtain advice to ensure that the correct amount of tax is paid on time may be one reason for an investigation being triggered, resulting in an increase in costs rather than a saving. Beneficiaries of an estate may be critical of PRs (or seek to bring a claim) if costs are incurred which would otherwise have been avoided as a result of the PR failing to declare the correct amount of tax due. This problem is only exacerbated where HMRC seek to apply penalties and interest that otherwise not be due if the correct amount of tax was paid on time.

Examples of recent investigations
Gift with reservation of benefit: It is quite common for a parent to transfer property into their children's names with a view to avoiding the need to pay inheritance tax on the property if they die more than seven years after the transfer. However, the parent often remains living in the property without paying full market rent, such that a reservation of benefit is created, and the property remains part of the estate for inheritance tax purposes.
In a recent case, a property owned solely by a parent was transferred into the names of the parent and two children jointly. The second child later decided to give up her one third interest, transferring it back to the mother and the first child jointly, due to a breakdown in relations with her sibling.
Over 20 years later, after the parent passed away, HMRC investigated the transfers, and held that the second child, who received no benefit from the property, was liable as the original donee for inheritance tax on the one sixth share of the property, which had been transferred back to her sibling. This was pursuant to the provisions under s199(1)(b) of the Inheritance Tax Act 1984 (IHTA) and paragraph 2(4) of schedule 20 of the Finance Act 1986, which confirms that where a donee gifts the share of the property they received to someone other than the donor for no consideration, they will be treated as though they continue to have possession and enjoyment of the property.
After significant submissions were exchanged, HMRC later conceded that the first child was at least jointly liable for the tax owed under s199(1)(c) and s205 of the IHTA because the share transferred back by child two vested in the first child, but they declined to pursue the first child alone for payment.
A request was made for the first child to pay the tax due, given that her sibling had received no benefit from the property. This was only agreed to after it was intimated that the second child would bring a claim seeking to set aside the gift of the one-sixth share on grounds of mistake, which would have resulted in the second child receiving one-sixth of the value of the property.

While the decision by HMRC may have been appealed if the tax had not been paid by the first child, this case demonstrates that HMRC will often apply technical rules stringently, regardless of the unfairness of the outcome.

Family trusts: When a trust is set up by a parent for the benefit of future generations, there can tend to be a lack of formality concerning the administration of the trust, and record keeping, which can cause difficulties later.

In a recent case, a family realised following their relative's passing that no steps had been taken to register or properly administer a family trust set up decades earlier, and it was unclear whether some property had been properly transferred to the trust, such that it may fall within the deceased's estate. The relatives of the deceased were unaware that they had been appointed as trustees, and the duties involved in carrying out that role. Despite previously being unaware of their obligations, it was important for the trustees to take steps to rectify the situation and ensure that the historic tax due in respect of the trust (which included inheritance tax) was paid.

Naturally wherever there has been an underpayment of tax, HMRC have to consider penalties. The crucial point in order to mitigate these is to control the narrative when explaining the position to HMRC and provide evidence (where possible) of the arguments relied upon.

Late payment interest rates on unpaid tax have been steadily increasing in recent years and are 7.5% at the time of writing. This means that if there is a delay in paying the correct amount of tax, the interest on the unpaid portion can be significant (in addition to the potential penalties).

Sources for tax investigations: nudge letters

HMRC have increased their use of 'nudge letters' in recent years, which are letters sent alerting them to potential underpayments, with a view to encouraging the compliance with tax regulations. They have been used as part of various campaigns such as a recent one to encourage the payment of tax on crypto assets. The sending of such letters can be triggered by information received by HMRC from various sources.

One of those sources is HMRC's use of a system called Connect, in addition to exchanging financial information with other countries. Connect allows HMRC to compare information provided by taxpayers with various sources such as bank, land registry, or DVLA records and information from online platforms. From an IHT perspective, if information declared to HMRC concerning a deceased's estate does not correlate with information declared by the deceased to HMRC during their lifetime, this could trigger the sending of a nudge letter or an enquiry which can be a time-pressure and expensive issue to deal with. In the event that a nudge letter is received, it is important not to ignore them to avoid this risk of this triggering a formal enquiry.

Conclusion

Complex arguments often arise between HMRC and experienced tax advisors regarding the interpretation of tax legislation, case law, and guidance, and so to many it seems unfair for beneficiaries or lay executors of estates to be punished with penalties (and interest) where they make a genuine mistake when trying to properly interpret the rules.

Where a mistake is discovered it is important to take prompt action in order to mitigate potential penalties. A cooperative approach with HMRC is usually advisable when an enquiry is commenced, and it is important for a reasonable position to be taken, with clear representations made in order to minimise additional areas that HMRC may need to clarify.

Enquiries or investigations can drag on for many months if not longer, impacting on the ability to make distributions from the estate while this is ongoing. This can also cause difficulties in cases where there are disputes ongoing regarding a trust or estate, as the level of funds available to settle any dispute will not be clear until HMRC has confirmed how much is due.

Once a decision has been made by HMRC, a cost benefit analysis will be required before pursuing an appeal before a tribunal. Where the decision is being made by a trustee or PR, even if advice has been obtained from experts, consideration should also be given to whether a Beddoe application should be made, seeking directions from the court as to whether the appeal should be pursued. This is to ensure that the PR or trustee do not become personally liable for any costs of the appeal, if it is later determined that they were not properly incurred. It is usual for a trustee or PR to consult with beneficiaries in advance of making a Beddoe application where appropriate, and if all the beneficiaries agree to the costs being paid from the trust or estate funds, this may mean that an application is not necessary at all.

Particular care needs to be taken by PRs when distributing estate assets, if an investigation has been commenced, or if there is any possibility of that happening, as there is a risk that they could find themselves personally liable for any shortfall if there are insufficient assets remaining in the estate to pay the sums due for inheritance tax.

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