Replacement Property Provision Guide

Foresight

Replacement Property Provision Briefing Note

Business Property Relief ("BPR") has become a popular route to mitigating inheritance tax ("IHT") for those requiring a solution that is effective in the short term and/or maintains access to and control over assets. However, the flexibility of the legislation can be under-appreciated and offers a valuable option to a particular subset of clients.

The Rules

The rules governing BPR are captured in the Inheritance Tax Act 1984 (sections 103 - 114). The act sets out both the terms of qualification…

"Where the whole or part of the value transferred by a transfer of value is attributable to the value of any relevant business property, the whole (of) that part of the value transferred shall be treated as reduced… by 100%*"

…as well as the provisions that apply in a range of circumstances. One of the more valuable provisions regards replacements and is commonly referred to as the "Replacement Property Provision" or "RPP".

RPP offers greater flexibility in the ownership of relevant property and access to BPR. In section 106, the act states that, to qualify for BPR, assets must be:

"Owned by the transferor throughout the two years immediately preceding (death)"

This suggests a continued period of ownership in the two years prior to death is required to qualify for BPR.

In the next section, "Replacements", the act states:

"Property shall be treated as satisfying the condition in section 106 above if it replaced other property and it, that other property and any property directly or indirectly replaced by that other property, were owned by the transferor for periods which together comprised at least two years falling within the five years immediately preceding the transfer of value"

There are alternative interpretations of this provision, however, it is generally understood to mean individuals must hold relevant property for a total of two years of the five preceding their death. This need not be a continuous period or indeed the same "relevant property". There are several further points that must be satisfied.

Key criteria for RPP to be satisfied

1. To meet the criteria for "replacement" the proceeds of one qualifying asset must be used to acquire the replacement
2. Each property must meet the definition of business property (other than the holding period) at the time of disposal
3. The final replacement must be held at death

*In some circumstances the relief is reduce to 50%. For example, where land and building are not owned by the business itself and AIM shares after 5th April 2026 until the second anniversary of the client holding Unquoted shares.

How is RPP used?

The provision allows individuals who have owned relevant property but have now sold those assets to reinvest the proceeds of sale and benefit from BPR. When calculating whether an asset qualifies for BPR we must add the periods of ownership of relevant property in the preceding five years to establish whether, taken together, these amount to a two-year period.

Where the cumulative period of ownership is under two years, the individual would need to hold new relevant property for the balance of the two-year period before the assets qualified for BPR. In these circumstances, should there be a large gap in ownership of relevant property, investors risk losing the value of RPP.

Example: If an individual held business property for five years to December 2015, sold the assets, then acquired replacement business property in March 2019, their immediate cumulative ownership would be 22 months. In this instance, the investor would have to hold replacement assets for a full two years (to Feb/March 2021) before qualifying for BPR. Until then, for each month gained, they would lose a qualifying month from the beginning of the five-year period.

Where the cumulative period of ownership is two years or greater, the investor can purchase new relevant property and immediately enjoy the inheritance tax benefits of a BPR qualifying asset. Where the cumulative period of ownership is two years or greater, the individual could purchase new relevant property which would immediately be considered as qualifying for BPR.

This provision is most commonly used in association with business sales.

Example of how business property relief can help mitigate inheritance tax

£3m

Mr Callaghan sells his business for £3m and, after paying off his mortgage and other expenses, is left with £1m in cash. He has no immediate plans for the money

£1m

Mr Callaghan has several options with his money

Mr Callaghan can remain invested in cash. In the event of his death, his beneficiaries would receive

£600,000

after IHT at 40%*

Mr Callaghan can reinvest in a BPR qualifying asset. Using RPP he would benefit from an immediate IHT exemption meaning the value to his beneficiaries is

£1,000,000

* Assumes Residence/Nil Rate Band is fully utilised by other assets.

BPR and RPP in the Spotlight

Mason vs. Mills & Reeve

In 2011, BPR and RPP were thrust into the spotlight when Mason, the daughter of Mr Swain (deceased), sued Mills & Reeve over their handling of his business sale and failure to address the issues of BPR and RPP.

The key features of the case were:

- Mr Swain was in the process of selling his business. Mills & Reeve were the solicitors acting on his behalf
- Prior to the sale, Mr Swain informed Mills & Reeve of a heart condition that would require routine surgery
- The sale was completed and, shortly afterward, Mr Swain died following an investigation in preparation for the planned procedure
- Since Mr Swain had sold a relevant property and now held cash, he had gone from holding an asset exempt from IHT to holding cash against which a substantial IHT bill was due
- Mrs Mason (and others) sued Mills & Reeve for professional negligence as Mills & Reeve failed to inform Mr Swain of the implications of moving from relevant property to cash or of the ability to replace these assets with other relevant property to benefit from RPP and immediate BPR qualification
- After several years in the courts, local press coverage and a significant investment of time and resources for both parties, the court found in favour of the defence
- It may have been possible to avoid litigation had Mr Swain been advised of the implications of sale and the options that were open to him

While this may have relevance for future business sales, the case has led solicitors and accountants who advise on business sales to review cases they have acted on in the preceding years. Where clients still hold the proceeds of sale, it may be possible to reinvest in relevant property and enjoy immediate BPR qualification taking advantage of the replacement property provision.

Warnings

- The act is not exhaustive on these matters and there are alternative interpretations of the rules. You should not act on the basis of this document alone and should seek professional advice on all tax matters
- Qualification for BPR is assessed on death and cannot be guaranteed
- Tax rules are subject to change
- Investing in small companies is inherently risky. These companies may not perform as hoped and some may fail completely
- Your capital is at risk; you may not get back as much as you invested and, in the worst case, could lose all of your capital
- BPR investment should be considered a long-term investment and may be higher risk and more difficult to realise than other securities listed on the London Stock Exchange

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