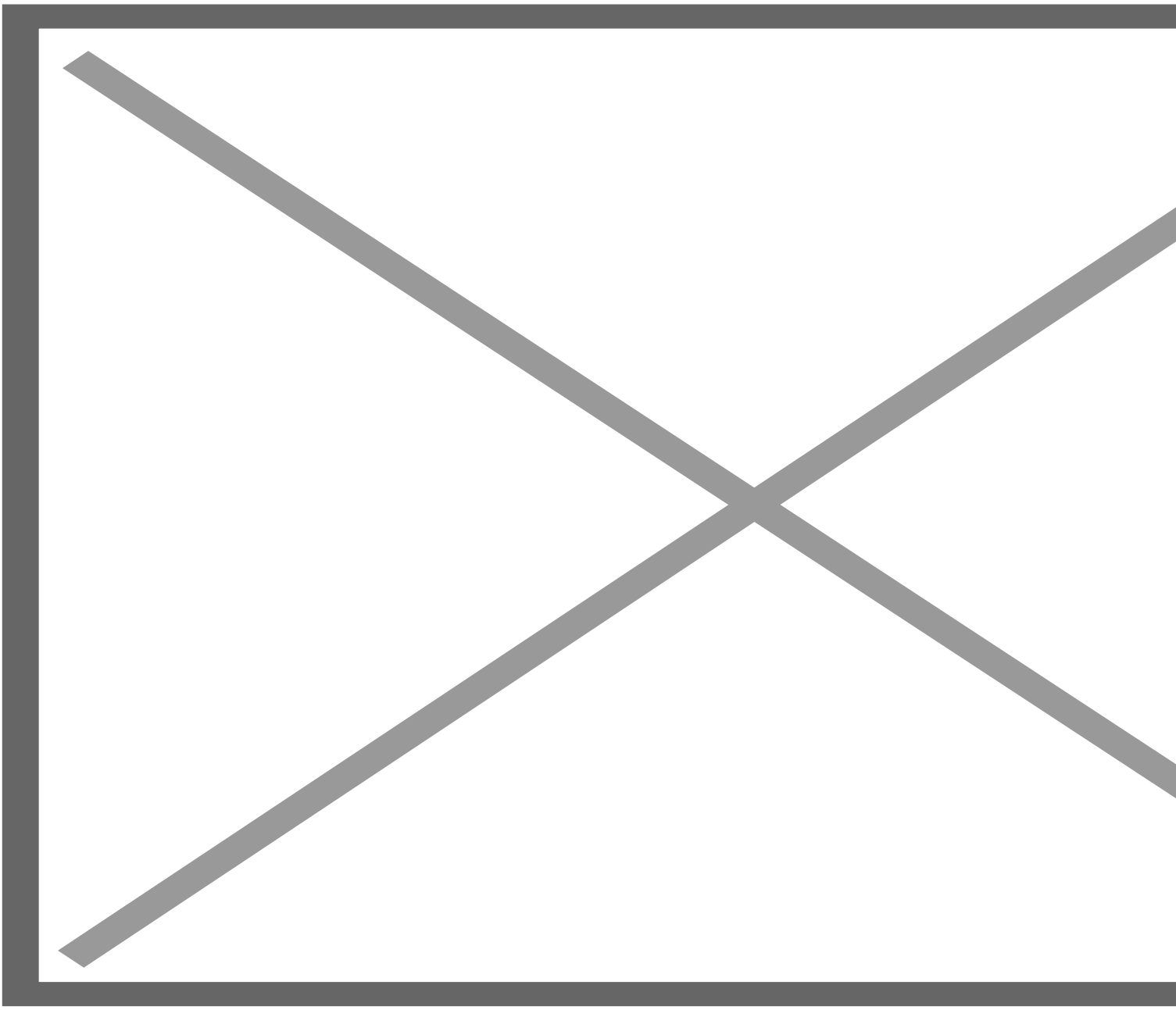
Keeping it in the family

Inheritance tax and trusts | Personal tax



02 March 2021

Emma Chamberlain examines the complexities involved in negotiating home loan arrangements and inheritance tax

Key Points

What is the issue?

Home loan schemes became a popular way of avoiding inheritance tax on the family home in the early 2000s. They were attractive to those who wanted to give away the value of their home but continue living there without a reservation of benefit problem and without losing main residence relief.

What does it mean for me?

After apparent initial acceptance, HMRC decided to challenge home loan schemes. The case of Shelford v HMRC has brought no greater clarity on the inheritance tax issues. Instead, it has raised new property law problems.

What can I take away?

In many cases the family of the deceased taxpayer will therefore have to choose between: claiming an inheritance tax deduction (the validity of which is disputed anyway at present by HMRC) and then suffering income tax or CGT on the loan when repaid; or avoiding income tax and possibly CGT by writing off the loan but then giving up any possibility of an inheritance tax deduction.

The home loan scheme (or, as it is sometimes known, the ‘double trust’ scheme) became a popular way of avoiding inheritance tax on the family home in the early 2000s. It seemed a good alternative to Ingram schemes that had been closed down in 1999 (see Finance Act 1986 s 102A). Few home loan schemes were established after the introduction of stamp duty land tax in 2003 as it was no longer possible to defer payment of stamp duty. Despite their relatively short shelf life of about three years, it is believed that some 30,000 schemes were executed.

I last wrote about home loan schemes for Tax Adviser in 2013, by which time it had become clear that, after apparent initial acceptance, HMRC had decided to challenge them. It has taken seven years for a case to reach the courts in Shelford v HMRC [2020] UKFTT 53 (TC) but this has brought no greater clarity on the inheritance tax issues. Instead, it has raised new property law problems.

This article and a second one consider the impact of Shelford within the general context of home loan schemes, including the current approach of HMRC. Many taxpayers with a home loan scheme have now died and their relatives need to consider the most appropriate options.

Reference should be made to the Inheritance Tax Manual where taxpayers wish to concede on home loan schemes (see bit.ly/2LBHhgc).
This first article will describe home loan schemes and the historic attack on them. A second article to be published next month will look at the four current challenges from HMRC to such arrangements, including the impact of Shelford.

Structure of home loan scheme There was no ‘single’ home loan scheme: they varied greatly in terms of documentation and particularly in relation to the loan. They were attractive to those who wanted to give away the value of their home but continue living there without a reservation of benefit problem and without losing main residence relief. An example home loan scheme is set out below.

Step 1: A life interest trust

Andrew is a widower aged 70 who owns a substantial property (worth £1.5 million with no outstanding mortgage). He would set up a life interest trust (House Trust) with £10 under the terms of which he was a life tenant with the right to enjoy the income of the trust and to enjoy the use of trust property. The trustees were given the usual modern flexible powers; for example, to advance capital to Andrew. (Often, Andrew would be one of the trustees.) The remainder beneficiaries of this trust were the adult children.

Importantly, this was a qualifying interest in possession (IIP) as it was set up prior to 22 March 2006; and therefore Andrew was treated for inheritance tax purposes as beneficially entitled to the property (see Inheritance Tax Act 1984 s 49). Hence, no inheritance tax arose either on setting up the trust or every ten years. However, on Andrew's death the trustees would be liable for any inheritance tax on the net value of the settled property in which he retained a qualifying IIP.

Step 2: Sale of the house

Andrew would then sell his house at market value to the trustees of House Trust. No gain would arise on the sale, as the house was his main residence; and no inheritance tax would arise as it was a sale, and a sale to a trust where Andrew had a qualifying IIP. The trustees did not have £1.5 million cash to pay for the house, so it was agreed that the purchase price would be satisfied by means of the issuance of a loan by House Trust. Alternatively, the contract simply stated that the purchase price could remain outstanding. (If a new house was being purchased, Andrew might lend cash to the trustees who would then purchase the new house.)

The sale of the house today would, of course, attract stamp duty land tax. Prior to 1 December 2003, stamp duty could be postponed by 'resting in contract'. Typically, the contract provided for the full purchase price to be paid over on exchange to the vendor as agent. Transfer of legal title was specified to be a long stop date in the future, e.g. 2025, and otherwise it was left to the purchaser to give notice.

> There was no 'single' home loan scheme: they varied greatly in terms of documentation and in relation to the loan.

If a contract of this sort was signed prior to 11 July 2003, no stamp duty was payable. However, in the event that the trustees are later registered with legal title, a stamp duty charge will arise based on the old rates and for the consideration specified then (4% if the consideration specified was over £500,000) (see Finance Act 2003 Sch 19 para 3). This assumes the contract is not varied or assigned. Where exchange and substantial performance was on or after 11 July 2003 and before 1 December 2003, then no stamp duty charge arose but stamp duty land tax was payable when transfer of the legal title occurs (see Sch 19 para 4).

Step 3: Treatment of the loan

Andrew would then give the loan away: either to the children outright or into a trust for their benefit ('Children's Trust') from which he would be excluded. The Children's Trust would also be IIP so the gift could take effect as a potentially exempt transfer (PET). If Andrew survived seven years, the intention was that the value of the loan would be outside his estate but the loan would be deductible against the value of his house in the House Trust on his later death. Obviously, any inheritance tax savings are not on the value of the whole house but limited to the value of the loan in respect of which it was hoped to claim a deduction.

The loan was usually expressed to be repayable only on Andrew's death, although the House Trustees could have the option to repay early. Sometimes it was interest free and sometimes indexed to the house prices index or the RPI. In some cases, the loan was (correctly) limited to the value of the assets in the House Trust, so that the trustees had no personal liability and could not distribute assets without first repaying the loan or notifying

the creditor. In other cases, these protections were not inserted. The hope was that by indexing the loan a greater inheritance tax deduction could be claimed on the death of Andrew. Since the loan could not be called in before Andrew's death by the Children's Trust, there was no risk of the House Trustees being forced to sell.

Sometimes, the original vendor (Andrew) would want to downsize. In these circumstances, the House Trust would sell the first house and buy a second. They could then, if they wanted, repay some of the outstanding loan using any surplus proceeds. There is a continuing debate about whether such repayment constitutes a PET. HMRC argues that it is, though the point remains untested.

The historic attack on home loans

Over time, taxpayers who had entered into home loan schemes found themselves in an increasingly awkward position (although unlike the Ingram or Eversden schemes, no specific targeted inheritance tax legislation was enacted).

First, pre-owned assets income tax (POAT) was introduced with effect from 6 April 2005. Although there were highly technical arguments to say that POAT did not apply at all to home loan schemes, nevertheless the intention was certainly that they should be caught. An annual income tax charge was levied on those who were still living in their homes – broadly equal to tax on the rental value. Every five years, a new valuation had to be obtained while (in our example) Andrew remained in occupation. To the extent that the house increased in value above the deductible loan, that excess was not subject to POAT. (For example, if the loan was £1.5 million and the house was worth £2 million, the taxable rental value under POAT would be 1.5/2 x market rent (see Finance Act 2004 Sch 15 para 11(1)).)

Secondly, from 22 March 2006 it was no longer possible to set up new qualifying IIP trusts during someone's lifetime or add to pre-2006 trusts.
This did not affect existing home loan schemes but made unravelling them more awkward.

Thirdly, from about 2011 HMRC announced that it did not accept that the home loan scheme 'worked' for inheritance tax purposes (see IHT44104).

Finally, for deaths after 16 July 2013, in order to be deductible for inheritance tax purposes the loan (even if incurred before this date) actually has to be discharged on death in money or money's worth (see IHTA 1984 s 175A(1)). The house therefore has to be sold on Andrew's death and the sale proceeds used to repay the loan to the children or the Children's Trust.

> The liability can only remain outstanding and be deductible if there is a real commercial reason for it not being discharged.

Depending on the terms of the loan, that repayment may itself trigger income tax (if the loan was structured as a relevant discounted security) or capital gains tax (if, as was often the case, it was a second hand debt). Prior to 2013, it had been hoped that the deduction would be claimed on death and later the loan would be written off by the Children's Trust (on the basis that the ultimate beneficiaries of the House Trust were the same), avoiding income tax charges. Writing off or releasing the debt is clearly not discharge for money's worth within s 175A and the loan will not then be deductible.

The liability can only remain outstanding and be deductible if there is a real commercial reason for it not being discharged, and securing a tax advantage is not a main purpose of leaving the liability undischarged (s 175A(2)). (One possible commercial reason might be that the debt had not fallen due for repayment on the first death

because the debt is not repayable until the last of husband and wife, which might occur where a couple sells their jointly owned house to the House Trust and they have joint life interests.) In many cases the family of the deceased taxpayer will therefore have to choose between:

a) claiming an inheritance tax deduction (the validity of which is disputed anyway at present by HMRC) and then suffering income tax or capital gains tax on the loan when repaid; or
b) avoiding income tax and possibly capital gains tax by writing off the loan but then giving up any possibility of an inheritance tax deduction.

The second article next month will look at current HMRC arguments.