Loans and debts

Inheritance tax and trusts | Tax voice

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Gary Heynes and *Kristina Volodeva* consider the various issues surrounding the use of loans and debts in estate planning for non-UK domiciled individuals and the impact of recent changes in the area

A quick recap

Domicile and the situs of assets are the only factors in determining an individual's liability to UK inheritance tax ("IHT").

As a result, the situs of an asset is a major factor for UK IHT; determining it though is not always straightforward and is generally done by reference to statute, case law and sometimes double taxation agreements. As a general rule, assets located in the UK are subject to UK IHT, both on death and in case of certain lifetime transfers, regardless of the domicile position of the owner. Non-UK situs assets are 'excluded property' for UK IHT purposes, meaning that they are outside the tax net, if owned by non-UK domiciled (actual or deemed) individuals ("non-doms"). Foreign situs assets settled on trust by a non-dom can be permanently excluded from UK IHT.

While the situs of most real assets can be determined relatively straightforwardly by their location, intangible assets create more of a problem. Shares are normally sited where they are registered or listed, bonds by where they have been issued and

intermediated securities may require consideration of whether they are opaque or transparent to determine whether to look at the security itself or the underlying assets.

Debts

Debts normally follow the situs of the debtor – the one who owes the debt. However, the situs of a ‘specialty debt’ – a debt under deed that needs to be formally signed, witnessed, delivered and is then enforceable by action – has historically been determined by reference to the physical location of the deed. This meant that keeping the deed outside the UK resulted in debt being foreign property, even if the debtor is resident in the UK. This could be very useful for a UK resident, non-dom because a debt they owe could be sited in the UK if they are resident but under Speciality would be excluded property (until they become domiciled – either actual or deemed).

Specialty debts settled by non-UK domiciliaries on trusts would also be ‘excluded property’ and as such not be subject to trust IHT periodic charges (on each ten year anniversary and on exit), potentially permanently.

On this basis, therefore, specialty debts historically constituted a commonly used, effective method of mitigating the non-doms’ and trustees UK IHT exposure.

But then…

The above tax treatment of specialty debts stemmed from long-established legal practice and case law and HM Revenue & Customs (“HMRC”) guidance. However, in 2013 HMRC made an unexpected U-turn on their views, updating their practice manuals to advise that judging a specialty debt by its deed’s location “*may not be the correct approach in all cases*” and such debts “*are likely to be located*” in the country of residence of the debtor (since January 2013), thus effectively downgrading a specialty debt to a simple contract debt, or the location of the collateral for the debt (since October 2013).

HMRC taking this position means that the previously afforded excluded property status would no longer be available to non-doms holding specialty debts outright if secured on UK property or issued to a UK resident. Trustees with loans extended to

UK resident beneficiaries could be deemed to be holding UK assets and have UK tax payment and reporting requirements.

Current state of play

The changes, both unexpected and seemingly unsubstantiated by either legal or technical analyses, does not seem to be ones about which HMRC are too certain either – the use of 'may' in the guidance is somewhat of a giveaway and the promise to produce something tangible to cement the 'new and improved' views on specialty debts has never materialised. This revised approach has been somewhat mentioned through the FA 2013 amendments made to section 874 (6A) Income Taxes Act ("ITA") 2007: "no account is to be taken of the location of any deed" for determining whether withholding tax should be operated on loan interest payments. However, no matter-specific commentary followed thus far, despite the clearly intended substantial impact the revised approach would have on individuals and trusts alike as well as requests for clarification and definitive comments and concerns voiced by tax and legal practitioners, STEP and ICAEW. Unscathed, HMRC for now seem to be just planning to refer all cases involving specialty debts to their Technical team.

As such, until and unless there is a precedent case, we are unlikely to know how the theoretical changes will apply in practice – and more importantly, from which point. It remains to be seen whether HMRC would seek to apply the change in views retrospectively, which begs the question as to whether legitimate expectation by those who have entered the previously unfrowned upon arrangements in good faith is sufficient protection from all but from the taxman.

And also…

In a further move to restrict the use of debts in estate planning, new rules on the deductibility of loans in calculating the value of estate or lifetime transfers for IHT purposes were introduced with effect from 17 July 2013, negating, in the majority of cases, tax relief for loans secured on UK assets but used to finance, directly or indirectly, the acquisition or maintenance of 'excluded property' or 'relievable property' (assets qualifying for Agricultural Property, Business Property or woodlands Reliefs) unless certain conditions are met. Traditionally, the position has been that the value of assets can be reduced by the value of the outstanding liabilities, including any mortgages and family loans, when calculating the taxable base for

IHT. The newly introduced restrictions can clearly have a substantial impact on those with complex or high value loan arrangements in place.

What now?

The practical reality is that specialty debts are an established category of formal contract in common law that has been in existence for many years and entering such arrangements may not always be a result of only the overwhelming desire to mitigate IHT exposure that HMRC believe has penetrated the non-dom society. With regards to deductibility of loans, it may not always be possible to get an advance other than by securing it on personal assets – consider an owner of a struggling trading company who can only get cash from the bank by offering personal assets as collateral – would any relief be due to him in case of an unfortunate event?

Given the changes in HMRC views, those individuals and trusts that have arrangements involving debts in place should exercise caution – whilst the position overall remains questionable in absence of any specific legislation, reviewing and restructuring should be considered. To the extent that no action is deemed possible or worthwhile, it is crucial to ensure that the existence of the arrangements is appropriately and fully reported – if only as a means of protection against a discovery assessment should HMRC choose to press rewind.