HOME LOAN ARRANGEMENTS

SETTING THE SCENE

47.100 The home loan (or as it is sometimes called the "double trust") scheme was a prime target of the Government when it introduced POAT. Although a "guesstimate", it has been suggested that as many as 30,000 of these schemes have been implemented. It was therefore the undoubted hope (and expectation) of the Government that the introduction of POAT would lead to taxpayers opting into the reservation of benefit provisions,[1] These are considered in detail in Ch.41. thus bringing scheme purchasers safely back into the IHT net. In fact surprisingly few elections have been made—apparently less than 5,000. Either home loan schemes have been dismantled or other options have been pursued.

47.101 Unlike *Ingram* or *Eversden* schemes, no targeted inheritance tax legislation has been enacted to stop these schemes although a series of measures have undoubtedly made home loan schemes less attractive. In particular, the fact that the loan must be repaid on deaths after 16 July 2013 in order to be deductible for IHT purposes (a measure introduced in s175A IHTA by FA 2013) has meant that some of the planning has become very problematic. The taxpayer may have to choose between an IHT or an income tax liability, and on occasion suffer both. As noted at the end of this chapter, a version of the home loan scheme has sometimes been used in the case of transfers of company shares between spouses even after the inheritance tax changes in 2006: this does not involve trusts and can avoid a POAT charge. The other deterrent to any home loan scheme involving land is the SDLT charge with effect from 1 December 2003. However, it is clear now that HMRC do not accept the home loan scheme "works" for IHTA purposes: in particular, they do not accept that the loan is deductible for IHT purposes or that there is no reservation of benefit in the gifted property. The IHT analysis in respect of "home loan" schemes between spouses is also discussed at the end of this chapter.

As a matter of terminology it is proposed to call these arrangements "home loan schemes" rather than "double trust" schemes for the simple reason that whilst one trust had to be employed, the use of the second trust (to receive the benefit of the debt) was a matter of choice. If preferred the debt could have been given outright.

47.102 HMRC's approach to Home Loan Schemes is considered at 47.404. Having taken fresh legal advice at the start of 2010, which was finally published in 2011, HMRC now considers that home loan schemes did not succeed in avoiding IHT. As at March 2017, HMRC have now started proceedings in respect of a number of home loan cases and litigation is proceeding, with the first case likely to be heard in early 2019. At the same time, they are encouraging taxpayers to settle by providing certain incentives both where the taxpayer unwinds the scheme during his lifetime and on death. In these circumstances one incentive to settle is that HMRC will refund all the past POAT that has been paid by the deceased less 40 per cent IHT. In addition, although a half-share of the house is subject to tax on the first spouse to die without the benefit of spouse exemption, if it is accepted that the scheme does not work on the first death then HMRC allow that part of the trust fund to remain IHT free on the second death. This can still result in IHT savings if the house increases in value between the two deaths.

HMRC's views on the home loan scheme were published in the Trusts and Estates Newsletter September 2017 and can be found at IHTM44120 onwards, extracts of which are published later in this chapter.

47.103 This chapter is organised as follows:

(1) how the schemes worked;

(2) the changing HMRC approach to the scheme;

(3) HMRC's arguments analysed;

(4) HMRC's new approach on the first and second deaths;

(5) does POAT apply to home loan schemes;

(6) options for taxpayers in relation to home loan schemes and the impact of the new residence nil rate band; and

(7) home loan variants.

How the Schemes Worked

47.200 There was no "single" home loan scheme: rather there were a number of variants. Also whilst many were sold as a package, others were bespoke.

Who Used the Scheme?

47.300 The demand for the scheme was generated by the significant rise in house prices in the 1990s which was not accompanied by a corresponding increase in the IHT nil rate band. The result was that many individuals found that simply by virtue of owning a house, IHT would be payable on their death. The home loan scheme was a way of avoiding inheritance tax with apparently no significant downside or loss of flexibility. In particular the main residence capital gains tax relief was not jeopardised.

47.301 It is possible to present the following "profile" of a typical home loan taxpayer:

(a) his house was worth at least £500,000 so that even if he had no other assets, IHT of over £50,000 would have been payable on the taxpayer's death;

(b) he was in his 60s or early 70s and likely to survive for at least seven years since the scheme involved the making of a PET and hence, for its success, required seven-year survival. However, people who hoped to survive even three years were often prepared to enter into the scheme on the basis that at least some tax would be saved, particularly if the house continued to increase in value; and

(c) it did not matter whether the property was freehold or leasehold but it was important that a disposal of the property would benefit from CGT main residence relief.[2] As to the conditions for this relief, see TCGA 1992 ss.222–226. The existence of a mortgage on the property was a complicating factor.

Of course, other individuals used the scheme: for instance, persons in their early 40s (rather young to be engaged in heavy IHT planning) and persons who owned other substantial assets (and who thereby neglected the cardinal rule that using the main residence in any tax planning arrangement should always be the option of last resort). It is also fair to say that some elderly

taxpayers who had no other inheritance tax planning options and might well die within seven years still entered into the scheme on the basis that "there was nothing to be lost".[3] In some cases the scheme was seen as a social accessory: "all my neighbours have one and therefore I want one!"

THE STRUCTURE OF A TYPICAL HOME LOAN SCHEME

47.302 One of the difficulties in considering the effect of the pre-owned assets charge on home loan schemes is the variety of schemes that were carried out. This chapter will discuss a number of variants because the options for taxpayers in each case following the introduction of the POA charge were different.

Take a typical taxpayer, Mischa, a widower aged 67 who owned a substantial property (worth £500,000 with no outstanding mortgage) in Rotting Hill. He wished to leave all his assets in due course to his daughter, Sasha, who is married with young children. The house benefitted from full principal private residence relief for capital gains tax purposes and Mischa thought that in a few years he might wish to relocate to Brighton and see out his days in the seedy glamour associated with that town.

Step 1: In 2002, Mischa set up a life interest trust ("Trust 1" or "property trust") 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: e.g. to advance capital to Mischa or to terminate his life interest. The remainder beneficiaries of this trust were Sasha and her family. (Note that this was a qualifying interest in possession being set up prior to 22 March 2006.)

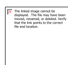
Step 2: Mischa set up a second trust ("Trust 2" or "loan trust") for the benefit of Sasha and her family. As this trust received a gift from Mischa with a value in the region of £500,000 (the current value of his house) it was important:

(a) that Mischa was wholly excluded from all benefit under this trust; and

(b) that the gift made by Mischa qualified as a PET for IHT purposes—hence before 22 March 2006 the trust could be interest in possession or accumulation and maintenance in form it but not discretionary. Alternatively, the gift made by Mischa could be outright to his daughter Sasha if he so chose although this was unusual.

Step 3: Mischa then sold his house to the trustees of Trust 1; they did not have the cash to purchase the property so Mischa made them a loan to enable the transaction to proceed. In effect, the purchase price was left outstanding as a debt owed by Trust 1 to Mischa. (In some cases where a new house was being purchased Mischa might lend cash to the trustees of Trust 1 who would then purchase the new house.) It was in the terms of the debt where the schemes tended to differ most markedly.

Step 4: The debt (i.e. the right to repayment in due course) was gifted by Mischa into Trust 2. Diagrammatically the position was as follows:



STAMP DUTY/SDLT

47.303 The sale to the trustees of Trust 1 would now attract SDLT: prior to 1 December 2003 (i.e. in the (good old) days of stamp duty) duty could be postponed by resting in contract. This was not possible after 30 November 2003 and in recent years SDLT rates have increased rapidly although the slab regime has been abolished. For all property transactions completing before April 2016, between £125,000 and £250,000 buyers will pay 2% within this band, 5% on the portion of the value between £250,0000 and £925,000, 10% within the next band up to £1.5 million and 12% over that. For additional properties such as buy to let or second homes, there will be a 3% surcharge applied to all bands if completion takes place from 1 April 2016. SDLT effectively killed off most home loan schemes.[4] See Chapter 51 for further information on SDLT rates.

What happened to all the pre–December 2003 schemes where the sale was never completed (thus leaving it "resting in contracts")? Typically, the contract provided for the full purchase price to be paid over as the deposit (and to be satisfied by the issue of a loan note) and gave vacant possession on exchange not completion. Completion was sometimes specified to be a long stop date in the future, e.g. 2025, and otherwise was left to the purchaser to give notice. If a contract of this sort was signed prior to 11 July 2003, then no stamp duty was payable then but in the event that the trustees (or a beneficiary) 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 FA 2003 Sch.19 para.3. This assumes the contract is not varied or assigned. Beware, therefore, registering the Property Trustees with legal title on the death of the vendor. It is better just to wait and sell the house onto a third party in due course.

Where exchange and substantial performance was on or after 11 July and before 1 December 2003, then no stamp duty charge arises but SDLT is payable when completion occurs. See Sch,19 para.4 and see examples in SDLTM 49400.

HMRC have recently argued that where the sale is not completed there is "no disposition" and therefore nothing has occurred for IHT purposes (although HMRC do not accept this). This argument is discussed further below.

Death of the taxpayer

On Mischa's death, in *Example 47.1* above, it was thought that the position was as follows:

a. he enjoyed a qualifying pre-March 2006 interest in possession in Trust 1 and so is subject to IHT on the house (see IHTA 1984, s.49(1)). On these facts and if we assume no movement in the value of the property, because the debt reduced the value of the house to nil, the result was that the net value of the property subject to IHT was nil (value of house exactly offset by debt owing)[5] Generally the debt was not charged on the house in order to avoid problems with s.103 of FA 1986. For confirmation that the trustees' liability reduced the value of the trust fund which was treated as Mischa's property under IHTA 1984, s.49, see *St Barbe Green v IRC* [2005] S.T.C. 288. For HMRC's view that the existence of the trustees' lien results in the application of s.103, *see* 47.407. ;

b. provided he had survived by seven years, the PET of the debt was left out of account (i.e. it was an exempt transfer); and

c. if Sasha was given an interest in possession in Trust 2 then her estate included the value of that debt. Normally, therefore, her husband was given a successive revocable life interest (with a view to taking advantage of the IHT spouse exemption). Alternatively, life insurance would be taken out to cover the risk of Sasha dying unexpectedly.

Terms of the debt

It was in the precise terms of the loan that the schemes varied significantly:

a. in some cases it was an interest free repayable on demand loan;

b. in others it was interest free but repayable only on the death of Mischa (or if Mischa was married then on the last of him and his spouse to die);

c. sometimes interest was payable and rolled up with the principal; in other cases the debt was indexed (e.g. by reference to a property index);

d. in some cases the loan was structured as a relevant discounted security but repayable on demand and in other cases as a relevant discounted security repayable only on the death of Mischa; or

e. the arrangement might involve the use of a tripartite loan agreement between Mischa and the two sets of trustees, thereby avoiding a separate assignment of the debt by Mischa. This might avoid a capital gains tax charge on repayment of the debt to Trust 2 (given that the trustees of Trust 2 would be the original creditor).

In some cases the trustees of Trust 1 incurred no personal liability for the debt. It could only be satisfied out of the assets of the Trust Fund and the trustees were not permitted to make distributions until it had been discharged. In other cases the trustees of Trust 1 did incur personal liability and the Trust Fund of Trust 1 was not specifically made subject to any lien.

APPROACH OF HMRC TO HOME LOAN SCHEMES

47.400 HMRC's initial approach was published in the 2005 pre-owned assets ("POA") Guidance Notes,[6] See Vol.3 Pt 5.8. which stated:

(a) in cases where the loan was repayable on demand because the trustees had not called in the loan they had conferred a significant benefit on the taxpayer in enabling him to continue to reside in the property "and therefore the debt was not enjoyed to the entire exclusion of any benefit to the vendor(s) by contract or otherwise".

(b) in cases where the debt was only repayable at a time after the death of the life tenant "since … the loan cannot be called in by the loan trustees it is generally thought that these schemes will not be caught as gifts with reservation".

Changes in Guidance

47.401 In October 2010, however, the Guidance was revised by the inclusion of the following sentence:

"

> HMRC is now of the view that these schemes (i.e. those in (b) above) are also caught as gifts with reservation. Further guidance, including the consequences for the POA charge, will be issued shortly.

”

The Guidance was reissued in 2011 as part of the POAT section of the IHT Manual and provided:

“

> A variant of the scheme described above is where the terms of the loan provide that the debt is only repayable at a time after the death of the life tenant. Since, unlike the position with loans repayable on demand, the loan cannot be called in by the loan trustees, it was previously thought that, in general, these schemes would not be caught as gifts with reservation. However, it is now HMRC's view that as the steps taken under the schemes are a pre-ordained series of transactions a realistic view should be taken of what the transactions achieve, as a composite whole, when considering how the law applies. This follows the line of authority founded on *Ramsay v IRC* [1981] 1 A.E.R. 865. The composite transaction has the effect that the vendor has made a 'gift' of the property concerned for the purposes of FA 1986 s.102 and has continued to live there. The property is therefore subject to a reservation of benefit.
>
> It is considered that this approach will apply to all variants of the home loan or double trust scheme and, where it produces a higher amount of tax, will be applied in preference to the position outlined above where the loan is repayable on demand.

”

HMRC Arguments

47.401A In fact, HMRC now consider that any home loan scheme fails to mitigate IHT for five reasons:

(1) FA 1986 s.103 applies with the result that the loan is not a valid deduction against the trust fund of the Property Trust;

(2) the so-called "*Ramsay* principle" applies so that the sale of the house is to be recharacterised as being a gift of the house and the continued occupation by the taxpayer involves a reservation of benefit;

(3) the scheme involves a series of associated operations so that there is a reservation of benefit in the loan;

(4) if the loan is repayable on demand it is subject to reservation of benefit.

(5) where the sale was left resting in contracts for stamp duty reasons, there is no disposition. As the settlor remains the legal owner the value of the freehold still forms part of his estate for IHT purposes. Presumably HMRC's case (albeit not explicitly stated) is that effectively nothing has happened.

It will be noted that these five grounds for saying that home loan schemes do not succeed in mitigating IHT each have differing consequences: in two cases there is a reservation of benefit in the gifted property (the loan); in one a reservation of benefit in the house and in the fourth a disallowance of the debt in the hands of the Property Trustees (Trust 1). In the case of the last argument, presumably HMRC deny that any value passed into the Property Trust and that the loan effectively does not exist as no disposition has occurred. Each of these grounds is considered in greater detail below.

47.402 In response to claims that the original POA Guidance was wholly misleading and resulted in taxpayers acting in reliance on that guidance paying the POA charge in order to "safeguard" the IHT benefits of the scheme, HMRC commented:

"

> You suggest our guidance is 'categorical'. With respect, whilst I would agree that the guidance as it relates to schemes where the loan is repayable on demand may be so described, I do not think that 'generally thought' can be considered a categorical statement.
>
> As regards the question of fairness between taxpayers, where our view alters, we are bound to apply that revised view to all working cases where the issue has not been settled, as well as to those that arise following the change in view. That is exactly what is happening following legal advice received at the start of this year.

"

47.403 HMRC's position may now be summarised as being that no home loan schemes are effective in achieving IHT benefits: a far cry from their initial statement that they are generally thought to be effective to avoid the reservation of benefit rules. In response to suggestions that taxpayers will have relied on the (old) guidance to their detriment HMRC has the following (slightly "Alice in Wonderland") argument:

"

> You suggest that if we had contended that a reservation of benefit existed in the house, the pre-owned assets charge would not have been paid. Surely this would only have been the case if it was generally accepted that HMRC's view was correct? As this was not the case, would your advice to clients really have been not to pay the POA charge AND deliver an account for IHT purposes on the basis that a reservation of benefit did not exist? Such an inconsistent position would be a risky strategy. If it was the taxpayer's belief (on advice) that a reservation of benefit did not exist, it would follow that the exemption from the POA charge was not available and in self-assessing their liability to income tax it is entirely proper that they should pay the POA charge. I do not see how our guidance would have had a material impact on that decision. And most certainly it could not have influenced whether or not the deceased established the structure in the first place.

"

Reliance on the Guidance

47.404 Such fantasy speculations do not disguise the fact that the original Guidance was wrong and no longer represents HMRC's views. Of course as a result of the original Guidance many taxpayers have paid the POA charge (wrongly if HMRC are correct) and chose not to dismantle their home loan scheme, believing that such scheme was accepted by HMRC. Indeed, in many cases after 2003 before the change in Guidance, HMRC did accept the efficacy of such schemes, generally allowing a deduction for the debt on the death of the settlor. By relying on that Guidance, taxpayers have effectively acted to their detriment. HMRC, however, argue that there is no detriment to the taxpayer: if the taxpayer had dismantled the scheme he would still have had to pay inheritance tax on death and so he was only worse off to the extent that POAT was paid.[7] Although POAT could be a substantial cost and therefore a substantial detriment. In many cases taxpayers will be out of time to reclaim the POAT paid since the four years has expired. It is presumably for this reason that HMRC will refund all POAT paid. This misses the point: in many cases taxpayers would have dismantled the home loan scheme if they

had thought HMRC might attack the arrangements. Some would also have taken further steps to mitigate IHT, e.g. by a co-ownership scheme or by sale and lease back.

Faced with these criticisms, HMRC now accept (and have settled cases on this basis) that in the following situations the debt is deductible so that the scheme achieved its objectives:

(i) the taxpayer died before the change in guidance and had relied on the 2005 guidance and paid POAT on the reasonable assumption that the scheme would be accepted as IHT effective by HMRC and the executors and trustees were prepared to take that point to judicial review;

(ii) if HMRC had previously enquired into the taxpayer's affairs and in particular the valuation for POAT purposes and had accepted that the correct amount of POAT had been paid. Informally with the editors, HMRC commented:

"

> With home loan schemes, there is a direct connection between the POA charge and IHT – if HMRC has agreed that the POA charge is properly payable it must follow that none of the [POAT] exemptions apply; and if the exemptions don't apply, it must be accepted that there is no potential IHT charge. Reading across to IHT, it is not unreasonable to take the view that the closure notice [for incom etax] could operate as 'clearance' for IHT such that HMRC is not able to re-open the matter on death.

"

47.405 In correspondence with the editors, HMRC stated that:

"

> where there has been an enquiry into the POA charge and HMRC has accepted that the charge applies, either in the figures returned or after adjustment, HMRC may not revisit the position on death. But where the POA charge has been paid and has not been the subject of an enquiry, HMRC is entitled to maintain on death that the home loan scheme is ineffective and seek to recover the IHT accordingly – although where it does so, allowance will be given for the income tax already paid.
>
> [8] See article in *Tax Adviser* January 2013, Technical Note on CIOT website January 2013 *http://www.tax.org.uk/Resources/CIOT* by Chamberlain and STEP Journal March 2013.

"

Recent developments in 2018

47.405A In a number of cases in which the editors have been involved, following a POAT enquiry during the lifetime of the deceased HMRC have accepted the IHT aspects "worked". However, more recently they have denied the existence of such a definite policy and therefore even this position is now unclear. It is important that executors of a deceased who had carried out a home loan scheme establish whether there had been any POAT enquiry into the taxpayer's return. If there had been such an enquiry and a closure notice had been issued, with or without amendment, then it may still be the case that HMRC will accept the scheme is effective for IHT purposes.

In addition, from the editors' experience in the past, HMRC appeared to accept that where the taxpayer died before the change in guidance and the executors submitted the probate papers

claiming a deduction for the loan that was initially accepted by HMRC and only later queried, the deduction would be given. However, HMRC now do not accept this is the case if the return was submitted after the change of guidance or HMRC started querying the position before the estate was wound up.

What is clear is that HMRC do not accept that the POAT guidance that was repeatedly reissued before the change in October 2010 is binding on them or raised any expectation that the taxpayer was entitled to assume that home loan schemes where the debt was not repayable on demand were accepted for reservation of benefit purposes. Where taxpayers can demonstrate that the deceased person did rely on the 2005 Guidance (whether directly or through advisers) and the deceased paid POAT on the reasonable assumption that the IHT savings would thereby be secured, it may be argued that HMRC are not entitled to resile on that guidance. However, this point is untested, although judicial review proceedings are being taken.

In the meantime the technical arguments on whether the home loan scheme actually works remain unresolved until litigation occurs. HMRC are now (as at October 2018) in the process of taking a home loan case to litigation. However, many taxpayers are choosing to wind up the schemes anyway since the introduction of the residence nil rate band has made the potential savings of the home loan scheme less necessary and HMRC offer a reasonable basis of settlement. The various ways in which home loan schemes can be wound up are set out below. Practitioners should note that if the taxpayer chooses to wind up the scheme HMRC *will* now refund all past POAT without time limit. This refund is best secured by liaison with the Inheritance Tax Technical Division. *See* guidance below. Presumably POAT refunds are being given on the basis that in 2005 HMRC wrongly (if their current view is right) said that POAT was payable in the first place. Some local offices are starting to write to taxpayers directly suggesting that they should not pay POAT any longer and instead accept the scheme does not work for IHT purposes.

If the position is only conceded on death POAT will still be refunded less 40% IHT (if due) on the taxpayer's death. See Example 47.2 below. However, as set out below, the position is not entirely straightforward if the scheme has not been wound up before the first death of a married couple.

Overall the approach of HMRC is to encourage taxpayers to give in by agreeing to refund the POAT and offering some form of protection on the property that is taxed on the first spouse's death.

Time limits

47.405B Where the taxpayer has submitted an IHT400 or IHT 100 return more than 4 years previously, do note that HMRC are likely to be out of time for issuing notices of determination even if they have enquired into the return. *See* 28.1201.

ANALYSIS OF HMRC'S ARGUMENTS ON HOME LOAN SCHEMES

First Ground: debts repayable on demand

47.406 The argument is that by failing to call in the loan, the trustees of the Debt Trust have conferred a benefit on the settlor because he has thereby been able to continue living in his house (which otherwise would have to be sold to pay off the debt). Many on demand loans

were structured so that if the trustees of the debt trust required repayment of the debt before the final repayment date (usually specified to be on a date equal to the likely life expectancy of the settlor) they would only have been entitled to receive the face value of the loan and would have forfeited any rolled-up interest. In other words the trustees of the Debt Trust did much better for their beneficiaries if they waited until the settlor's death. So the question is whether the trustees of the Debt Trust were required to act to their positive detriment in order to avoid a reservation of benefit problem for the donor?

In any event, the donor derives no benefit from the loan itself. If he derives a benefit at all, it is from occupation of the house, which, on the basis of cases such as *St Aubyn v AG (No.2)* .[9] [1952] AC 15. may be regarded as property separate from the gift. A similar point crops up in relation to carve-outs and trusts and also in relation to insurance arrangements. For example, if the settlor has kept an income interest (e.g. a life interest) but the trustees have the power to terminate that interest and do not do so, is a benefit conferred on the settlor? Trusts provide all sorts of indirect benefits for donors which are not regarded as involving a reservation of benefit. For example, one might argue that a trust set up for the settlor's children which pays their school fees, leads to a benefit being conferred on the donor which results in a reservation of benefit but HMRC do not take this point. Not all benefits remotely linked to the gift can be said to fall within the reservation of benefit rules and the Court of Appeal has specifically held that the benefit has to cause some detriment to the donee. If the loan is worth more if the donee waits then failing to call in the loan does not caused a detriment.[10] See further the *Buzzoni* decision discussed at 5A.239A.

Second Ground: disallowance of the debt under FA 1986 s.103

47.407 HMRC presents the argument as follows:

"

> s.103 is plainly designed to disallow the deduction of artificial liabilities. If a liability is to be taken into account in establishing the value of an estate, then it is capable of being a 'debt' or an 'incumbrance' within s.103. That much seems clear from the opening words of the section. Whilst the loan may not have been secured on the property, will it not have given rise to an equitable lien in favour of the trustees against the property in respect of their indebtedness to the deceased? Will not that lien then be an 'incumbrance' and was it not brought into being ('created') by the disposition? You may argue that as the lien arises by operation of law it was not created by the disposition. But something that arises by operation of law still has to have a trigger, something still has to cause it to come into existence and the only possible trigger here is the disposition made by the deceased. So a liability that is to be taken into account is an incumbrance that was created by a disposition made by the deceased. S.103 therefore operates to abate the loan.
>
> Is there another issue here in that if the property is not encumbered by the debt created by the sale of the property to the trust and it is a personal liability of the trustees, what are the grounds for taking the debt into account in valuing the deceased's estate at death if the trustees cannot have recourse to the trust assets to fund a call to repay the loan?

"

The argument is derived from comments in McCutcheon on Inheritance Tax (6th edn, 2013) at para.25.97. It should be noted that the argument having been raised, the editors of that book then reject it on the basis that:

(i) the incumbrance was not created by the sale of the property to the trustees: rather it follows from the rights of reimbursement which trustees have against the trust fund (see generally for the right of reimbursement TA 2000 s.31(1) and Lewin on Trusts (19th edn, 2015, Ch.21).

(ii) the property sold to the trustees was not consideration for any incumbrance: it was consideration for the debt.

So far as the final point made by HMRC above is concerned, the majority of debts and liabilities incurred by trustees will be personal liabilities (albeit with a right of reimbursement against the fund) but deductible for IHT purposes.[11] See *St Barbe Green v IRC* [2005] STC 288. On this basis no debt incurred by a qualifying interest in possession trust set up by a settlor in which he retains a life interest could ever qualify for an inheritance tax deduction. The *Barbe* case did not suggest this.

Third Ground: operation of the *Ramsay* Principle

47.408 HMRC considers that *Ramsay* applies as follows:

> "
>
> … the rule is one of statutory construction—we are required to take a realistic view of what the transactions achieve, as a composite whole, when considering how the law applies.
>
> Lord Hoffmann analysed the nature of the principle in the following terms in *BMBF v Mawson* 76 T.C. 446 at para.[32]:
>
> '
>
>> The essence of the new approach was to give the statutory provision a purposive construction in order to determine the nature of the transaction to which it was intended to apply and then to decide whether the actual transaction (which might involve considering the overall effect of a number of elements intended to operate together) answered to the statutory description. Of course this does not mean that the courts have to put their reasoning into the straitjacket of first construing the statute in the abstract and then looking at the facts. It might be more convenient to analyse the facts and then ask whether they satisfy the requirements of the statute. But however one approaches the matter, the question is always whether the relevant provision of statute, upon its true construction, applies to the facts as found. As Lord Nicholls of Birkenhead said in *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd* [2001] UKHL 6 at [8], [2001] 1 All ER at [8], [2003] 1 A.C. 311: "The paramount question always is one of interpretation of the particular statutory provision and its application to the facts of the case".
>
> '
>
> The statutory provision is s.102 of the FA 1986. Following Lord Hoffmann's approach, we should first analyse the facts. The transactions were part of a widely marketed tax avoidance scheme specifically aimed at circumventing the reservation of benefit provisions. They did so by creating the appearance of a sale, but without any intention that the donor would retain any value on disposal of the property. I do not consider it unreasonable to take the view that a 'sale', where it was always intended that the 'consideration' would be passed on by way of gift can be treated, for all intents and purposes, as a gift of the original property. And it was always the primary purposes of the scheme that the deceased's occupation of (the property) should continue undisturbed.

> We must then consider whether the facts, viewed realistically, satisfy the requirements of the statute on a purposive construction. The purpose behind s.102 is well known—where a person makes a disposal by way of gift but they retain a benefit in the gifted property, the property is treated as remaining part of their estate.
>
> Realistically, the transactions, as a composite whole, put the deceased in the same position as if … she made a gift of the property and continued to live there — where s.102 would apply without question. Against that backdrop, a purposive interpretation of the word 'gift' in s.102 would reasonably encompass all the steps undertaken as part of a home loan scheme.

"

47.409 The assertion that a sale of the house in the situation where the proceeds are to be given away can be categorised as a gift of the house sold is striking. Does it follow that a taxpayer who sells qualifying business property and settles the proceeds is to be treated as settling the business property? It should also be noted that arguments based on *Ramsay* were given short shrift in the *Ingram* litigation. More recently HMRC have argued that it is a sale at an undervalue as it was not on commercial terms. This may have more merit but the question is whether that matters.

Even if the sale to the property trust (the interest in possession trust in which the settlor took a life interest) was at an undervalue the donor took a qualifying interest in possession so that any reservation of benefit is displaced by FA 1986 s.102(3). In response to this, HMRC argue that the interest in possession is only in the "net value of the settled property" and therefore the settlor reserves a benefit in the debt element.

This would be a startling result in other circumstances. For example, a trust with a qualifying pre-March 2006 interest in possession may borrow commercially. On HMRC's analysis the life tenant has an interest in possession in the net value of the settled property. When the borrowing is repaid he gets an interest in possession in more property, which is then non-qualifying!

The correct analysis is surely that the settlor has a qualifying interest in possession in the whole settled property (thus displacing reservation of benefit under s.102(3)) but the value for tax purposes is the net value after taking account of liabilities incurred for full consideration. Although there are some statements in *St Barbe* that may not be entirely clear this seems the only logical way of applying the legislation. HMRC however do not accept this. They will proceed at the moment by collecting IHT on the basis that there is a ROB in the house not the loan. *See* guidance extracts below.

Fourth Ground: a series of associated operations

47.410 HMRC put its argument based on associated operations as follows:

> A further alternative is that the transactions undertaken are associated operations within the meaning of s.268. This is relevant in view of the terms of para.6(1)(c) Sch.20 FA 86. Under that provision, any benefit that the donor obtained by virtue of any associated operations of which the disposal by way of gift was one, shall be treated as a benefit to the donor "by contract or otherwise". This is important in view of the second limb of s.102(1)(b) FA 1986. If it is the case that the arrangements conferred a benefit on the deceased that is referable to the gift, that benefit is to be treated as a benefit by contract or otherwise which falls within s.102(1)(b).

> Prior to the transactions taking place the deceased owned [the property] absolutely. After the disposal to the trust took place, s/he was no longer the owner, although as beneficiary under the Property trust, the trustees had the power to allow [her/him] to continue to occupy the property. The sale of the property in exchange for a loan note could, depending on the terms of that note, give the noteholder a significant influence over what was to become of [the property] and the extent to which the deceased could continue to live there undisturbed—which is, of course, an essential part of the scheme.
>
> Whilst the loan note remained in the deceased's hands, its precise terms made little or no difference to her/his circumstances he/she was unlikely to take any action that would upset her/his enjoyment of her own home. But given that the intention of the scheme was to give the loan note to the trustees of the Second trust, the terms for its repayment take on some significance. Had the loan allowed the noteholder to request repayment on demand, the deceased's ability to continue to live at [the property] undisturbed was at risk. If the noteholder chose to call in the debt, the trustees would almost certainly have to sell the property which would see the deceased lose her/his home.
>
> But by making the loan repayable only after her/his death, the deceased ensured that her/his continued occupation would not be disturbed. That is plainly a benefit to her/him and one that arose directly from the terms of the loan that was given away. The benefit arises within the terms of para.6(1)(c), so the loan note should properly be regarded as subject to a reservation of benefit under s.102(1)(b).

47.411 Even if the gift and prior sale are associated operations within IHTA 1984 s.268 it remains difficult to see how the taxpayer has benefited from them. Specifically there is nothing in the legislation to require an extended meaning to be given to what has been given away and the Ingram case provides House of Lords authority for the principle that before seeking to apply the reservation of benefit rules it is necessary to identify precisely what has been given away. In that case, for instance, the fact that the arrangement involved carving out a lease (retained by the taxpayer) and giving away the freehold, did not result in a benefit being reserved in the gifted freehold interest irrespective of the fact that the nature of the gift meant that the freeholder had to allow the donor to continue living in the property.

Fifth ground – no disposition argument

47.411A While full beneficial ownership of the property sold does not pass before completion for IHT purposes, the settled property comprised in the Property Settlement is nevertheless effectively the benefit of the Sale Agreement. The value of that agreement is of no significant difference from the house in valuation terms since the Trustees could at any time acquire full beneficial ownership of the home by requiring completion of the contract. Although the Trustees may not be full beneficial owners of the land, the value of the settled property in which the settlor has an interest in possession is effectively the same.

In short, there is by reason of IHTA s.49 no diminution in the value of the deceased's estate as a result of the contract and no gift. That does not mean that there was no disposition. As Lord Walker notes in *Jerome v Kelly* [2004] UKHL 25; [2004] 1 W.L.R. 1409; [2004] 5 WLUK 275 at para 32, under an uncompleted contract for the sale of land, beneficial ownership of the land is split between the seller and the buyer but the purchaser still has a proprietary interest.

Audley agument

47.412 HMRC have cited the case of *Audley v HMRC* [12] [2011] UKFTT 219 (TC). as evidence the scheme will fail. However, this case related to whether an allowable loss for income tax purposes was realised on the assignment of the relevant discounted security and came down to

an analysis of "the price paid" for the loan note. The Tribunal held that, in effect, the loan note (a relevant discounted security) was worth far less than its face value when issued by the trustees of the property trust in consideration of the transfer of the house to them. However, this point does not have any bearing on whether the loan note is deductible for IHT purposes on the settlor's death. The debt was incurred by the trustees for (more than) full consideration. It was not held the loan was a sham and should be ignored. Nor is the case relevant to any of the other arguments raised by HMRC.

POA tie-in with HMRC's arguments

47.413 Even if HMRC are right and there is a reservation of benefit in the debt, this does not necessarily mean that there is no POAT charge. The "relevant property" for the purposes of this tax is the house and the donor has satisfied the disposal condition by the sale to the interest in possession trust. Whilst the para.11(1) exemption applies to the equity in the house, the reservation of benefit property (the loan) does not form part of the donor's estate for IHT purposes while he is alive so that the debt remains an excluded liability and so reduces the value of his estate.[13] See FA 1986 s.102(3). The position is the same if the debt is disallowed under FA 1986 s.103. HMRC comment in the revised POAT guidance that income tax will be refunded if the litigation results in there being a reservation of benefit. But if there is a reservation of benefit in the debt, HMRC may insist that both POAT and IHT is due!

The long awaited test case—2012 and 2018

47.414 A test case where the loan was not repayable on demand was taken in early 2012 with notices of determination and appeals. In the meantime other estates were held up; this in turn meant that until the outcome of the litigation was known it was not clear whether the Property Trust or the Debt Trust or the executors (or none) would be liable to pay any inheritance tax and therefore a certificate of tax deposit could not easily be purchased to stop interest running.

To deal with this problem, in their August 2012 Newsletter HMRC commented as follows:

"

> HMRC is aware that in a number of estates, the correct treatment of home loan schemes for the purposes of Inheritance Tax (IHT) and the pre-owned assets charge is the only matter to be resolved and is holding up the administration of the estate being wound up. In order to allow executors and trustees to deal with the estate as far as possible HMRC will, on request, provide an estimate of the tax that might be payable should litigation find in HMRC's favour.
>
> Executors and trustees may then choose to make a payment on account with HMRC to stop further interest accruing, or they may make and retain an appropriate reserve from funds in their hands. Where money is paid on account, HMRC acknowledges that this does not signify acceptance of HMRC's view and in the event that litigation is decided in favour of the taxpayer, HMRC will then adjust the IHT position as necessary and refund any money that has been overpaid.

"

47.415 In December 2012 the "test" case settled in favour of the taxpayer. Although inheritance tax was repaid HMRC did not accept the technical merits of the scheme. HMRC agreed that the loan was deductible for inheritance tax purposes but only on the particular facts of that case which were:

(a) The taxpayer who died before the change in guidance had relied on the 2005 guidance and paid POAT on the reasonable assumption that the scheme would be accepted as inheritance tax effective by HMRC and the executors and trustees were prepared to take that point alone to judicial review;

(b) HMRC had previously enquired into the taxpayer's affairs and in particular the valuation for POAT purposes and had accepted that the correct amount of POAT had been paid.

In fact it was not the apparent reliance on the old guidance that made HMRC settle the case. HMRC commented:

"

> With home loan schemes, there is a direct connection between the POA charge and IHT – if HMRC has agreed that the POA charge is properly payable it must follow that none of the [POAT] exemptions apply; and if the exemptions don't apply, it must be accepted that there is no potential IHT charge. Reading across to IHT, it is not unreasonable to take the view that the closure notice could operate as 'clearance' for IHT such that HMRC is not able to re-open the matter on death.

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As at October 2018, the editors are aware that a number of home loan cases are being litigated by HMRC with HMRC issuing notices of determination in respect of a number of other cases.

HOW ARE HMRC TREATING HOME LOAN SCHEMES NOW? NEW APPROACH ON FIRST AND SECOND DEATHS

47.417 In schemes entered into by spouses, there is a new approach in relation to the position on first and second deaths. See 47.405 for POAT position.

47.417A HMRC have every incentive in settling cases if they can collect the tax without going to court. Hence HMRC have been helpful in enabling taxpayers to settle without incurring further IHT charges on the write-off of the debt and in giving POAT refunds. This is explained further below. HMRC have also begun to impose charges on the first death of a married couple if the scheme is still in place even if the executors indicate that they will not claim an IHT deduction for the loan on the last death. This can cause cash flow problems although may may mean that less IHT is paid overall. HMRC published guidance in September 2017 as set out below.

"

> Taxpayers may want to unwind home loan or double trusts schemes they entered into. Unwinding these schemes will have consequences for Inheritance Tax (IHT) and the following pages set out our approach if this happens. By unwinding we mean that taxpayers will effectively have negated all the IHT effects of what they had entered into, and it will, on the whole, put them back into the position they were in before entering into the arrangement …

"

"

> *Current basis of settlement* At present, where the scheme has not been unwound HMRC are prepared to settle cases, prior to a judicial decision, on the basis that a GWR arises in the house or other property comprised in the settlement in which the settlor had a qualifying life interest to the

extent the house or other property is subject to the loan (see the examples in the following pages). We would then expect to see the value of such property included as a GWR in the estate of the deceased person on death.

Where property was settled jointly we would expect to see the deceased's share of the property in which they had an interest in possession reflected in their estate on death. No joint property discount or spouse exemption is applicable. This would mean that IHT has to be paid on the first death on their share to the extent it is subject to the loan.

HMRC's view is that the qualifying interest in possession (IIP) does not exist in the property to the extent it is subject to the loan (FA 86 s.102(3) does not apply). The deceased does retain a qualifying interest in possession in the excess value over and above the loan which can qualify for spouse exemption. The examples in the following pages make this clear.

"

"

Unwinding schemes If the home loan or double trust scheme is unwound during the taxpayer's lifetime then (assuming the house remains in their estate at death) it will again be subject to IHT on death as an asset of their estate. However, unlike the position above joint owners will be able to claim spouse exemption where the property passes to the surviving spouse. In that event the tax charge on the whole property is deferred until the death of the surviving spouse.

"

"

Cessation of reservation When the scheme is unwound during the taxpayer's lifetime (either by the loan being assigned back to the taxpayer or written off) the property is no longer subject to a reservation of benefit, and the whole house (or other property comprised in the qualifying IIP trust) is part of the taxpayer's chargeable estate without a deduction for the loan. The GWR provisions provide that when a property ceases to be subject to a reservation of benefit the taxpayer is deemed to have made a potentially exempt transfer at that time. There is no loss to the taxpayer's estate when the reservation ceases as a result of unwinding, so long as the property becomes comprised in the taxpayer's estate.

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Pre-Owned Assets: Unwinding Of Home Loan Or Double Trust Scheme: Joint Settlor Schemes Unwound After First Death

Where one joint settlor dies, before the scheme is unwound, Inheritance Tax (IHT) may already have been paid on their share of the property, as a gift with reservation (GWR), at the time of their death. When the surviving joint settlor dies the whole value of the property could be reflected in their estate where the outstanding loan is disallowed as a liability under IHTA 84 s.175A. Where the scheme is unwound the whole property will be reflected in the surviving spouse's estate on death. Unwinding the scheme would then result in more IHT becoming due than if the settlors had never entered into the scheme.

We have agreed that we will settle these cases, on the death of the surviving spouse, on the basis that half the value for the property held in the interest in possession (IIP) trust, on the first spouse's death, will not be brought into charge as part of the estate of the second spouse. The half share held by the surviving spouse will be brought into charge on their death without any allowance for a joint property discount. This agreement applies only to schemes unwound between the deaths of the joint settlors.

If the whole property is subject to the loan, and is taxed on the first spouse's death, because the first spouse was the sole settlor and it passes outright or on IIP trusts to the surviving spouse, the house is not brought into charge on the second death. As explained later, in relation to lifetime gifts or downsizing, it will be necessary (a) to unwind the scheme between the first and second death and (b) to demonstrate that the property passing to the surviving spouse has been kept ring-fenced where it is later sold during the surviving spouse's lifetime.

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Example This example shows how the property should be returned on the IHT 400 account for each joint settlor who has entered into a home loan or double trust scheme.

First Settlor The settlors each transferred one half of the value of Property A into a home loan or double trust scheme. On the death of the first settlor we would expect to see their half-share of the value for the property liable to Inheritance Tax on death as a GWR. The IHT 400 account should still declare the first settlor's interest in the IIP trust even if the net value is nil.

Settled Property:

One half share of Property A: £300,000

Less one half of the outstanding loan: -£300,000

Net value of settled property: Nil

GWR:

One half share of Property A: £300,000

"

"

Second Settlor and Second Death As the scheme has been unwound the second settlor is now either the sole life tenant of the IIP trust (home loan settlement), or the property has been appointed to them absolutely. Where the property is no longer subject to the loan the entire value of Property A would now be reflected in the second settlor's estate and it would be liable to IHT so half would be taxed a second time.

Settled Property/Solely Owned Property:

Entire value of Property A at date of second death: £650,000

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"

The open market value of the property has increased by £50,000 by the date of the second death.

"

"

Agreement with HMRC If the scheme is unwound between the deaths of each settlor (so the loan is written off or appointed back to the second settlor) then HMRC agree that the charge on second

death extends to one half of the value of the property. The IHT 400 account submitted for the second settlor should include the value of the property, but reflected as a half share with no joint ownership discount applied.

Assets—unwound home loan scheme:

One half share of Property A: £325,000

”

“

It should be clear on the account that the second settlor unwound their home loan scheme, prior to death, and the value returned for the property represents the share of the property now subject to IHT. If the second settlor or surviving spouse did not unwind the home loan scheme prior to their death and the loan remains outstanding, the loan will be disallowed as a deduction (IHTA84/S175A). The whole property value will be subject to IHT on the second death.

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47.417B HMRC then go onto discuss variants on the above, making it clear that if IHT is due on the value of the loan on the first spouse’s death and the scheme is unwound but the loan is less than the value of the property, half the value of the loan will be taxed on the first spouse’s death, the excess value over the loan will have the benefit of spouse exemption and then on the second death the house will be subject to IHT apart from a percentage share attributable to the loan that has already been taxed. See examples below. HMRC also confirm that a full refund of POAT is given. Note that this will be an asset of a deceased taxpayer’s estate and so could be subject to IHT.

“

Pre-Owned Assets: Unwinding Of Home Loan Or Double Trust Scheme: Pre-Owned Asset Charge

When the home loan or double trust scheme has been unwound a repayment of all the pre-owned assets (POA) Income Tax without time limit paid to date can be claimed by writing to:

Pay As You Earn and Self-Assessment

HM Revenue and Customs

BX9 1AS

United Kingdom

The taxpayer should enclose signed copies of the documents used to unwind the scheme in evidence. A POA repayment will only be made when the scheme has been unwound.

A number of examples may help to illustrate the above principles outlined by HMRC. (Practitioners should read the full guidance for further assistance if winding up schemes.)

”

(1) *George*, a widower, has died with a home loan scheme in place. His house was held in a qualifying interest in possession trust for him and on his death passes to the children outright and on his death was subject to a loan for its full value (£1 million). He has been paying £50,000

POAT per annum since 2005/06 for ten years. The executors and trustees notify HMRC that they do not intend to defend the scheme. Tax on an additional £1 million will be paid on George's death but HMRC will refund £500,000 POAT less 40% tax = £300,000 net refund. This is used to reduce the additional IHT payable. Note that this example does not take account of residential nil rate band that may also be available.

(2) Facts as above except that *George* was married to *Isobel* and they are joint life tenants. On his death, he has a qualifying interest in possession in half the trust fund and *Isobel* has a transitional serial interest in his share as that now passes on trust for her for life. He leaves his free estate to her on death. Assume the value of half the loan is equal to half the market value of the house and assume that half the house is worth £500,000. HMRC do not accept any spouse exemption is available on *George*'s share of the house passing to Isobel. Instead IHT is charged on *George*'s half share of the house i.e. on £500,000 payable in instalments but the trustees can claim the benefit of any unused nil rate band to reduce the tax payable on *George*'s death. HMRC refund *George*'s POAT of £250,000 and this sum is spouse exempt as it passes under his will to Isobel. They will also refund Isobel's POAT of £250,000 (instructing the local tax office accordingly provided Isobel formally accepts that the loan is not deductible—it is generally safer to write off the loan in these circumstances). Provided *George*'s share of the house is kept segregated and not mixed with Isobel's free estate, on her death his share is not subject to IHT. So, if *Isobel* dies and by then the value of the house has increased to £1.5 million from £1 million, £750,000 of the trust fund remains free of IHT (even though *Isobel* has a qualifying IIP in the same!). On *Isobel*'s death, after April 2017, she can claim the benefit of the residential nil rate band (including *George*'s RNRB) to reduce the tax on her share. See Ch.6.

(3) Facts as in (2) above, except that on *George*'s death the house was worth £1 million and the loan only £800,000. On that basis, £100,000 will be spouse exempt on his death and £400,000 chargeable (£1 million less £800k divided by two), i.e. 80% will be chargeable. On *Isobel*'s death the house is worth £1.5 million. £750,000 (her share) will be chargeable plus 20% of £750,000 = £150,000 as this part was exempt on *George*'s death. The balance (£600,000|) will be free of tax on *Isobel*'s death provided she has kept the proceeds ring fenced (and it is therefore preferable that the Property Trust is retained even after the house is sold.)

It should be borne in mind that IHT is not the only tax that needs to be considered. In the above example the debt itself could show a significant gain at George's death compared with the original value when it was assigned. This gain is taxable on repayment if the holder of the debt is not the original creditor or it is a relevant discounted loan. Even if the scheme is wound up the gain still has to be dealt with and may be chargeable. This is discussed further below. As a general point HMRC accept that a write off of the loan owed by the property trust holding the house is not an addition of property to the property trust for IHT purposes but an addition of value. Therefore it should not be a chargeable transfer for IHT purposes if the settlor still has a qualifying interest in possession at the time of the write off. HMRC treat it as a PET.

If the loan is a relevant discounted security there should be no income tax or CGT arising on the write off. The position is trickier where the loan is a chargeable asset for CGT purposes. See below.

47.417C The position can be summarised as follows in relation to a married couple who jointly effected a home loan scheme:

Joint settlors, both alive. Scheme wound up.

(a) if schemes are unwound whilst both settlors (the parents) are still alive there is no deemed PET made by either of them assuming that the loan is either written off by the Debt Trust in favour of the Property Trust or otherwise comes back into the settlors' estates. This is because there is no deemed PET under s.102(4) FA 1986 when reserved benefit property itself comes back into the parents' estates and HMRC accept that there is no addition of property to the Property Trust when the loan is written off, only an increase in value. There is, of course, a PET made by the children who have an interest in possession in the debt when it is written off. HMRC accept that this is not a chargeable transfer.

(b) The parents will continue to have qualifying interests in possession in the house (if the Property Trust continues) and on the first death spouse exemption will be fully available as there is no longer any debt.

(c) The new residence nil rate band may be available on the last death if the house is "closely inherited" i.e. the children or other lineal descendants take outright on the death of the last spouse. Note however that it is necessary for the children or remoter issue to take outright on the last death. Those interests must not be subject to any continuing overriding powers after the last settlor to die. This is likely to require some change to the existing terms of the property trust.

(d) Any POAT that has been paid will either be refunded immediately or credited against the inheritance tax due on the survivor's death.

Joint settlors, one dies. Position on first death if scheme wound up.

(a) Assume joint settlors but the first settlor has died. HMRC argues (a) there is a reservation of benefit in the house and (b) the reservation of benefit in the house is limited to the value of the loan but that the value of the loan is equal to half its face value even if not repaid until after the second death. (c) there is no spouse exemption to the extent there is a reservation of benefit.

(b) If a beneficiary has a qualifying interest in possession in the house it does form part of their estate and s.102(3) is to that extent displaced. HMRC argue that there is no qualifying interest in possession in the house to the extent its value is attributable to the debt. This follows the argument noted above that HMRC claim the settlor has an interest in possession only in the net value of the property and reserves a benefit in the value equal to the loan. HMRC argue there can be no spouse exemption on reserved benefit property even though in this case such property may become comprised in the surviving spouse's estate.

(c) HMRC tax the first settlor's estate on his death to the extent of his share of the market value of the loan and then exempt that value on the second spouse's death. If HMRC charge the whole of the first spouse's share in the house to IHT on the first death then whatever that half share (or the relevant sale proceeds if the house has been sold) is worth on the second death it will be free of IHT provided the house or the sale proceeds are kept ringfenced. So if the house is worth £1 million on second death £500K is not charged.

(d) Hence the main disadvantage of not winding up the scheme before the first death for joint settlors is cash flow, i.e. clients have to pay the inheritance tax earlier than would otherwise be the case. Equally, if the value of the deceased spouse's share increases in value after his death

that increase in value is entirely free of IHT. The surviving spouse should therefore give away or spend from their *own* half share and keep the first spouse's half share ringfenced as it is now exempt from IHT.

One settlor. Position if scheme wound up before or after death

Refund of POAT during lifetime if the scheme is wound up while the settlor is alive. No further POAT payable. No PET provided the loan is written off. If it is repaid then HMRC argue this is a deemed PET under s103 FA 1986.

If the scheme is only wound up on death then the POAT is still refunded (but as it is then an asset of the free estate that refund will in itself usually be subject to 40% IHT on the settlor's death) and full IHT is payable on the value of the home. The loan will still have to be dealt with – either by being written off or in some cases by repayment out of the sale proceeds of the house. Obviously significant problems can arise if say one of the children to whom the loan has been gifted on IIP trusts or outright has died as HMRC still collect IHT on the value of the loan at the child's death. There is no allowance for that IHT against the IHT payable by the estate on the death of the settlor.

DOES POAT APPLY TO HOME LOAN SCHEMES?

47.418 For a POAT charge to apply, the requirements of Sch. 15 para.3 are met since:

(a) the individual (Mischa: see Example 47.1) occupied land; *and*

(b) the disposal condition was met given that he owned an interest in that land after 17 March 1986 and that he disposed of the property otherwise than by an excluded transaction.

47.419 However, there are the following arguments against a POAT charge applying. In the editors' view, the second, fourth, fifth and sixth of these are the most likely to succeed.[14] It is assumed in this section that the scheme succeeded in avoiding the reservation of benefit rules. For HMRC's approach, see 47.400.

1. The sale to Trust 1 was a transaction such as might be expected to be made at arm's length between unconnected persons: see para.10(1)(a). If it was such a transaction the POAT charge does not apply.
2. The sale to Trust 1 was a non-exempt sale: see para.4(4). If so, the imputed rent and therefore the tax charge would be nil (see para.4(2)).
3. The loan was not an "excluded liability".
4. The loan was an excluded liability but did not "affect" the house (see paras.11(6), (7)). If it is not such a liability the full value of the house is treated as comprised in the estate and the POA Regime does not apply (see para.11(1)(a)).
5. The charge does not apply when the house is sold and the trust holds cash or other intangibles.
6. The POA charge does not apply if the settlor lent cash to the trust, it then purchased a house occupied by the settlor. A loan of funds is not a provision of funds for the purpose of contribution condition and the disposal condition is not satisfied. The fact that the settlor subsequently assigned the debt to another trust does not seem to matter. See 33.115, Example 33.3(d), 37.218 and 37.301, Example 37.14.

Each of these arguments will be examined in turn.

First argument: Is it an arm's length transaction?

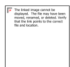
47.420 The editors do not consider that the sale to Trust 1 is protected as an excluded transaction.[15] *See* FA 2004 Sch.15 para.10(1). It was a sale of Mischa's whole interest in the property but was it "a transaction such as might be expected to be made at arm's length between persons not connected with each other"? The sale has a number of features not present in a commercial sale (notably the deferment in the payment of the price/financing the arrangement by a vendor loan).[16] An alternative way of viewing the home loan arrangement would be to see it as satisfying the contribution condition given that the loan is used to discharge the trustees' obligation to pay the purchase price. Arguably bounty has been "provided". In that event the exclusion in para.10(1)(a) would not give protection from the POA charge anyway because this paragraph only affords an exemption from the disposal not the contribution condition.

Second argument: Is it a non-exempt sale?

47.421 A non-exempt sale is defined (in Sch.15 para.4(4)) as a sale of the individual's "whole interest in the property for a consideration paid in money in sterling or any other currency" which is not an excluded transaction: i.e. it is a sale at an undervalue. Mischa is certainly selling his whole interest to Trust 1 at an undervalue[17] *See* 47.402. but has consideration been paid? The answer may depend upon the particular scheme used: in cases where the consideration for the sale is satisfied by a sterling loan it is certainly arguable that because nothing remains payable under the land contract and the purchase price has been satisfied by the acceptance of a debt the requirement is satisfied.

47.422 What is the result if the non-exempt sale rules apply? Given that the sale price will be equal to the then value of the house, "the appropriate proportion" will be nil (see the formula in para.4(4)).

Using Mischa as an example:



If that appropriate proportion is then applied to find the appropriate rental value (under para.4(2)) DV will be nil and so the rental value will be nil.[18] See 33.208 for further comments on non-exempt sales. One difficulty with this analysis is that the home loan scheme may well satisfy the contribution as well as the disposal condition in that an element of bounty has been "provided" to the trustees of Trust 1 which has enabled them to purchase the property. In that event the non-exempt sale provisions give no relief. However, HMRC have now accepted that a loan is not the provision of consideration and does not satisfy the contribution condition.[19] *See* 5.13 and for further consideration of loans *see* 33.112. On that basis there is no POAT due because even though the disposal condition is satisfied the actual charge is nil.

Third argument: Is the debt an "excluded liability"?

47.423 As discussed elsewhere,[20] See Ch.37 and FA 2004 Sch.15 para.11(1). POAT will generally not apply if the property is comprised in the individual's estate. Given that Mischa in our example is the life tenant of Trust 1 (which owns the property), it will form part of his estate for IHT purposes.[21] See IHTA 1984 s.49. Doubtless realising that this would exclude the home loan scheme from the Regime, the draftsman of the POA legislation introduced the concept of an "excluded liability".[22] See 37.217 for the meaning of an "excluded liability". This is defined in para.11(7) as:

“

> a liability is an excluded liability if
>
> (a) the creation of the liability, and
>
> (b) any transaction by virtue of which the person’s estate came to include the relevant property or property which derives its value from the relevant property or by virtue of which the value of property in his estate came to be derived from the relevant property were associated operations, as defined by s.268 IHTA 1984.

”

Under para.11(6) if the value of Mischa’s estate is reduced by an excluded liability “affecting” any property, that property is not to be treated as comprised in his estate. This provision is intended to operate in the following way. Assume that the value of the house is now £550,000 and the debt remains £500,000.

(a) To the extent that the value of the property exceeds the amount of the excluded liability (£550,000 — £500,000) the exemption from the Regime in para.11(1) operates. This is consistent with the general scheme of the legislation since £50,000 will be included in Mischa’s estate for IHT purposes; and

(b) As to the amount of the excluded liability (£500,000), the Regime applies (in percentage terms to 90 per cent of the value of the house).

The above assumes, however, that the value of the excluded liability to be taken is the face value of the debt: *see* 37.218 for a consideration of whether it is the face value or the discounted value that is to be used.

47.424 The definition in para.11(7) limits an excluded liability to one where the creation of the liability and any transaction by virtue of which the person’s estate came to include relevant property. Arguably Mischa’s estate included the property when it was sold to Trust 1, since it then became comprised in his estate under IHTA 1984 s.49(1). Given that Mischa had owned the house for a number of years, it might be said that selling the property to the trust did not affect Mischa’s inheritance tax position (there was certainly no transfer of value at that time). However, even if the liability was a subsequent event wholly unconnected with Mischa’s original acquisition of the property, the definition of an associated operation is in the editors’ view wide enough to cover the debt.

Specifically, it does not matter that the creation of the debt was not in contemplation when the house was originally purchased. The operations can still be associated.

The meaning of associated operations

47.425 Operations are associated under IHTA 1984 s.268 if one of two heads is satisfied. Head (b) provides that where any two operations are effected with reference to the other they are associated. In this case the original purchase of the house by Mischa (the transaction by which it became comprised in his estate) was not done with reference to the creation of the debt because the purchase occurred many years earlier.

47.426 However, Head (a) provides that operations are associated if they affect the same property or one of which affects some property and the other of which affects property which represents directly or indirectly that property. The question in Mischa's case is whether these operations are over the same property: does the debt affect the house or represent the house? It is not charged on the house and it is not clear that it represents indirectly the house. The house is still there. On the other hand the debt would not have arisen if the house had not been sold and the debt is derived from the value of the house.

47.427 For IHT purposes, the operations need to form *part of a disposition* by associated operations and in the light of *Macpherson v IRC* [23] [1988] S.T.C. 362. and *Reynaud v IRC* ,[24] [1999] S.T.C. (SCD) 185. it is thought that a series of associated operations which are not connected in terms of intention cannot be part of a single disposition for inheritance tax purposes even under Head (a). One might also argue that the purchase of the house might be an associated operation but is not a *relevant* associated operation because it was not at that point intended to confer a gratuitous benefit—see the *Reynaud* case where the Special Commissioner said that an associated operation is relevant only if it is part of the scheme contributing to the reduction in value of the estate. However in that case the point was that it was the *second* associated operation which contributed nothing to the diminution of the estate which had *already* occurred.

In fact, one could argue in the context of the home loan arrangement that neither the creation of the debt nor the purchase of the house as such diminish the settlor's estate. What diminishes his estate is the gift of the debt. So it may be that neither of the operations listed in para.11(7) are in fact relevant even if associated!

47.428 However, the difficulty is that para.11(7) merely refers to associated operations under IHTA 1984 s.268 and an operation can be associated without being relevant for IHT purposes. For the purposes of the POA charge it is the association that is important and it is thought that the test of relevance does not apply.

Fourth argument: If the debt is an excluded liability does it affect the value of the relevant property— namely the house?

47.429 There is only a charge under POA if the liability "affects" the property and it might be argued that the property is only affected if the debt is charged on the property or otherwise impacts on its nature or value. So if the debt was given outright to an individual or a company, it would not affect the property unless secured.

Cate lends cash to a wholly owned company (interest free) which purchases her house. She retains the debt. The company's liability is an excluded liability within the para.11(7) definition but since that liability does not affect the house, the excluded liability rule does not apply. Cate has made a disposal of the property which is not an arm's length excluded transaction. The company shares and loan are in her estate and derive their value from the house. Therefore the value of the relevant property is in her estate and no POA is due.

If Cate sells the house to an interest in possession trust for herself and gives away the loan (as would normally happen in a home loan scheme) then is the house "affected" by the debt? In the editors' view the answer is yes.

47.430 In almost all cases the liability is unsecured. However, in many home loan schemes the trustees are expressly made liable only in their capacity as trustees and in that capacity have specific recourse to the assets comprised in Trust 1: i.e. against the house. The trustees have a lien over the trust fund. It is therefore difficult to argue that the house is not in some way "affected" by the liability.

In some home loan schemes the trustees are personally liable and there is no specific recourse to the assets comprised in Trust 1. It may then be said that the property is not affected by the liability although the trustees would still have a right of recourse to the assets of the trust and therefore arguably the property is still affected by the liability.

Fifth argument: It cannot apply to intangibles

47.431 In some cases the house will have been sold and the trustees of Trust 1 will merely hold cash and securities, i.e. intangibles. In these circumstances if the settlor retains a qualifying interest in possession and the settled property is subject to debt owed to the children or to another trust, HMRC considers that the para.9 charge applies, i.e. the intangibles charge. However, for the reasons outlined in 36–111, the editors consider that the settlor has not "provided" any of the settled property to Trust 1 (other than possibly £10) and therefore the charge cannot apply once the house has been sold.

Conclusion

47.432 What might have seemed obvious—that the Regime will catch home loan schemes—turns out on consideration to be much less certain. Of course, it will be surprising if the Regime does not apply (given that such schemes were a principal target). Nevertheless, there is sufficient doubt to mean that some taxpayers may take the view that they will self-assess on the basis that POA income tax is not due. If they do this then they would want to put full disclosure of their reasons in the white space of the tax return so that the Inspector was made aware of any "insufficiency" and the taxpayer is protected from a discovery assessment. Taxpayers should not take this option unless they are prepared to argue the point out with HMRC and ultimately be prepared to pay the income tax if they lose.[25] *See* Ch.43.

OPTIONS OPEN TO TAXPAYERS

47.500 If the POAT Regime does apply to taxpayers who entered into a home loan scheme (and as indicated above there are a number of reasons why it might not do so), what are their options now? The table at the end of this chapter summarises the main options. Any discussion can only be of a general nature given that so much will depend on the particular scheme adopted by the taxpayer, the values involved and the appetite of the family for litigation given the Revenue's current attitude to home loan schemes, but the following general points should be noted. It is assumed in all cases that the home loan scheme was effected prior to 22 March 2006.

Option 1: Pay the income tax and/or consider repaying (part of) the loan

47.501 Before taking any decision, the taxpayer should calculate the POA income tax charge that will be payable if he does nothing *and* the POAT Regime applies. This meant obtaining a market value for the house as at 6 April 2005; identifying the amount of liability and obtaining a rental value of the house at that time. A further valuation was required on 6 April 2010 and

then again on 6 April 2015. The income tax charge may not be as large as feared, particularly if the loan is interest free and the house has increased in value.

A, a higher rate taxpayer, effected a home loan scheme in 2003. The house was worth £1 million with a rental value of £40,000. The loan's face value was £800,000 but its commercial value given that it was not repayable until *A*'s death is £400,000. The loan is interest free.

A's income tax charge for the year 2005/6 (and thereafter until the tax year 2010/11) will be £40,000 reduced by the amount of property still in his estate. If the value of the excluded liability is £800,000 this means that 80 per cent of the market rent is the deemed benefit, i.e. £32,000 = income tax (at 40 per cent) of £12,800.

If the value of the excluded liability is £400,000 then only 40 per cent of the rent is taken as the taxable benefit, i.e. £16,000 giving an income tax charge of £6,400. If part of the loan is paid off during the five years then a revaluation of the loan is made (and POAT reduced accordingly), but the land is not revalued.

The editors, however, consider that the correct view is that the excluded liability is £800,000 and HMRC follow this approach.

A may decide to pay the annual income tax charge. This will be particularly attractive where he is likely to move out of the house soon or become non-UK resident or he is in ill health and does not think that he will live long.

If by 2015 the house is worth £2 million and the rental value is £60,000. The loan value is still £800,000. On that basis the taxable benefit has fallen as only 40 per cent is subject to POAT i.e. £800,000/2,000,000 x £60,000 = £24,000.

47.502 A point to bear in mind is that if the annual rental value of *A*'s house is less than £5,000 (£10,000 for a married couple who both entered into the scheme) the de minimis exemption applies and *A* is not subject to POA income tax at all.[26] For de minimis, *see* Ch.39.

47.503 In order to reduce the annual taxable benefit *A* might be able to repay part of the debt owed to the Debt Trust. For example, by adding cash to the Property Trust so that the trustees repay enough of the debt to reduce the taxable benefit to within the de minimis levels.

Any inheritance tax savings are preserved but *A* has to find funds to repay the debt. Those monies would need to be paid by *A* into Trust 1 for the trustees of that trust to effect partial repayment of the debt owed to Trust 2.

A disadvantage of repayment is that it may trigger an income tax charge on the children's trustees (Trust 2) to the extent of any profit realised if the loan is a relevant discounted security or has provided for interest to be rolled-up. Moreover since 22 March 2006, any addition of funds to either the Property or the Debt Trust is a chargeable transfer by *A*.

HMRC also argue that repayment of the loan is a deemed PET under FA 1986 s.103(5) or FA 1986 s.103(4).

Could the donees, who stand to benefit from any IHT savings, pay the income tax on *A's* behalf? Does this cause a reservation of benefit problem?

This question was asked of HMRC and the correspondence is contained at Volume III section 5.14 correspondence between HMRC/CIOT question 4. HMRC confirmed (both in relation to home loan and other schemes) that there is no reservation of benefit if the donee puts the donor into funds to pay the income tax liability on schemes undertaken before the Regime was introduced provided that the income tax is not paid out of the property originally given by the donor.

Option 2: Unscrambling the scheme

47.504 There are a variety of ways in which a home loan scheme could be unscrambled. Much will depend on how the debt was structured. HMRC have been generally helpful in facilitating unscrambling without incurring immediate IHT charges.

Unscrambling if the loan is not a relevant discounted security (an "RDS") — assignment of the debt

47.505 When the debt is not a relevant discounted security it may be possible to unscramble the entire arrangement as follows:

The basic scheme involves the benefit of the debt being assigned to the settlor (or settlors if a married couple effected the scheme) and aims to attract double charges relief in the event that one of them dies within seven years of the gift of the debt. (This point is now largely irrelevant as home loan schemes were all completed before 2003 so the settlor has survived the seven years.)

Stage 1

47.506 If the benefit of the debt is transferred to the children outright by the trustees of Trust 2 and the children then assign it back to the settlor(s) each child will make a PET. To avoid this, the trustees of Trust 2 (the children's trust) may appoint the capital value of the debt to the children (who already have interests in possession) contingent on their being alive in (say) 21 days. During the 21-day period the children assign their benefits under that appointment to the settlor(s). (Note that the children retain their existing qualifying interests in possession which will terminate only when the contingency is met after 21 days.) So far as the children are concerned this assignment will not have adverse tax consequences since:

(a) for IHT the assignment is of a reversionary interest (i.e. a future interest under the settlement) which is excluded property[27] For the definition of excluded property, *see* IHTA 1984 s.48(1)(3). ;

(b) for CGT purposes the disposal is of an interest under a settlement on which, as a result of TCGA 1992 s.76(1), no chargeable gain accrues unless Trust 2 is non-UK resident.

The making of the appointment by the trustees will not have any tax consequences. There will, of course, be consequences when the condition is satisfied.

Stage 2

47.507 At the end of 21 days the settlor(s) becomes absolutely entitled to the debt which is then owed by the property trustees (Trust 1) to the settlor(s). The Children's Trust (Trust 2) has ended as a result of the appointment. Although the children's qualifying interests in possession

have terminated there is no charge because of reverter to settlor relief that is still available even after 22 March 2006 provided that the settlor(s) take absolutely. The debt is not at this point written off. If the settlor were to die within seven years of having entered into the home loan scheme the position (after Stage 1 and Stage 2 have been effected) is as follows:

(a) he is taxed on the value of the house in Trust 1 less the value of the debt which is owed by those trustees. Hence any tax charge will be limited to the growth in value of the property above the amount of the debt;

(b) in addition the benefit of the debt is in his free estate and accordingly taxed. However, reg.4 of the 1987 Double Charges Regulations will prevent there being a charge on both the failed PET of the debt and on the debt itself which is comprised in the settlor's estate.[28] Note, however, that relief would not be available unless the gifted property is received back from the original transferee: hence problems may arise if the debt trust was originally A-M in form or if the interests in possession were originally held by different beneficiaries.

47.508 The end result is that the scheme has been unscrambled and whilst the settlor has obtained no IHT advantage he has not suffered any IHT double charge. The main problem is often CGT as the debt is not always an exempt asset and the appointment of the debt then results in CGT.

The tax consequences of Stage 2 are as follows.

(a) The children's interests in possession in Trust 2 have ended with the absolute vesting of the trust property in the settlor. This does not involve the children in making a PET because of the availability of reverter to settlor relief.[29] *See* IHTA 1984 s.53(3), and on reverter to settlor trusts generally *see* Ch.48.

(b) On the ending of Trust 2 no CGT charge will arise provided that the debt falls within TCGA 1992 s.251(1) (which provides that no chargeable gain arises on its disposal). In many cases the trustees of Trust 2 will not be the original creditor and therefore a CGT charge will arise on the increase in value of the loan (charged at 20 per cent on the trustees from April 2016).[30] This is where the various schemes differ: if the debt had been assigned to the trustees of Trust 2, for instance, so that they are not the original creditors then any gain (and, of course, the debt may not be standing at a gain) will be chargeable. If the debt is a relevant discount security, its transfer may trigger an income tax charge. CGT can be a major problem now on home loan schemes where the Children's Trust is not the original creditor. Any write off, repayment or appointment is likely to trigger CGT.

(c) Any past POAT can be refunded.[31] Initially the local income tax offices have refused to refund more than four years POAT on the basis of normal time limits but now do refund the full amount on the basis that the taxpayers were misled by HMRC into paying POAT in the first place as it was never due. No further POAT is payable even if the scheme is wound up half way through the tax year.

47.509 Diagrammatically this unscrambling arrangement is as follows.

47.510 The structure can then be collapsed. Before 22 March 2006 this could have been done by (i) the settlor releasing the debt to the trustees of Trust 1 and (ii) the trustees subsequently appointing the house—free of debt—to the settlor absolutely.[32] For SDLT beware FA 2003 Sch.16 para.7 or Sch.4 para.8. From 22 March 2006 it was arguable that the release of the debt owed by the trustees of Trust 1 (who hold the house) is a chargeable transfer for inheritance tax purposes although

the editors consider that this is wrong: the release of a debt is not an addition of property to the trust but has merely made the settled property, in which the existing interest in possession subsists, more valuable. It is now understood that HMRC also take this view and do not regard any write off of the debt as a chargeable transfer whether this is done by the settlor or by the children. In the latter case HMRC say it is a PET as it has made the value of the settlor's interest in possession in the Property Trust more valuable but reduced the value of the children's interests in possession. This makes it much easier to sort out the SDLT position. It is no longer necessary to transfer the house out of the Property Trust subject to a debt. Be careful that the write off of the loan by the settlor is not held to be consideration for the appointment of the house back to the settlor otherwise SDLT could arise.

If the Property Trust ensures the property passes to the children outright on the settlor's death this will secure any available residence nil rate band relief. Otherwise it is not "closely inherited."

47.511 So far as the POA charge is concerned once the debt is back in the settlor's estate, even if it remains outstanding, the excluded liability (i.e. the debt which affects the house) does not reduce the value of the settlor's estate so that the POA charge will not apply.[33] Sch.15 para.11(6). It is thought that for these purposes the settlor's estate must be looked at "in the round": namely as the aggregate of the settled property and his free estate (contrast the approach adopted in *St Barbe Green v IRC* [2005] S.T.C. 288). If the debt is written off then there is no excluded liability.

A resume of the double charges position— assignment vs release of debt

47.512 The problem of the double charge can best be illustrated by an example. Suppose the children do not assign their interests in the debt to the settlor but simply write it off and the settlor dies within seven years of entering into the scheme. In that event the PET the settlor made becomes chargeable and inheritance tax is due on it. However, the house is now fully chargeable to inheritance tax since the debt has ceased to exist. So, in effect, the family could end up paying inheritance tax twice on the same economic value. It is to deal with this situation that further relief was announced on 21 July 2005.[34] *See* Ch.42 and Inheritance Tax (Double Charges Relief) Regulations (SI 2005/3441); reproduced in Vol.3, Pt 2. These give specific relief where the debt is written off or released: *see* 47.515.

47.513 If the children give the debt back to the settlor who then dies within seven years of entering into the scheme, the debt is still in existence. Hence it can be deducted against the value of the house. Provided that the original gift of the debt was to a qualifying interest in possession trust for those children since the gifted property is now back in the settlor's estate, he only pays one lot of inheritance tax either on the failed PET or on the debt. The calculation that produces the higher amount is the one taken. The end result is that the same inheritance tax is paid as if the inheritance tax planning had never been done. If the home loan scheme was carried out by a married couple then in order to obtain double charges relief it would have been necessary for them to leave the house to the children *rather than each other* on the death of either of them in the seven–year period running from the original gift. This problem is largely academic now as the settlor will by definition have survived seven years from the date any home loan schemes were done (as none were effected after 1 December 2003).

Unscrambling if loan note is an RDS—write off of debt

47.514 If the loan note is an RDS then the above method of unscrambling may involve income tax charges for the debt trustees if the RDS shows a profit on assignment. In some cases it has been structured in such a way as to avoid a profit arising.[35] For instance, if the RDS is limited to the value of the trust assets and the house has not increased in value since the assignment of the debt then there will be no taxable profit. A commercial valuation of the RDS should be undertaken. If only repayable on the death of the taxpayer any taxable profit is likely to be small. However, if income tax is a problem then unscrambling is likely to involve the following steps.

(a) Vary the Debt Trust so that only adults are beneficiaries. (Step 1)

(b) The trustees at the request of the adult beneficiaries release or write off the RDS. (Step 2) Step 2 increases the value of the settlor's interest in possession in the Property Trust but HMRC now accept this is not a chargeable transfer. They do not allow reverter to settlor relief but consider it a PET by the children.

The analysis of these steps is as follows:

(a) By ensuring that only the adult beneficiaries can benefit the trustees effectively put them in a *Saunders v Vautier* position. Although it might be argued that the trustees of the Debt Trust are benefiting the settlor who is an excluded person, there is no breach of trust because the waiver would be carried out at the request of all beneficiaries. It is important to ensure that the narrowing of the class to adult beneficiaries is valid. So for example if the trustees are also the settlors or beneficiaries care should be taken to ensure that the trust deed allows trustees to enter into transactions in which they have a personal interest. It might be argued that Step 1 was made for an improper purpose, i.e. fraud on a power, as the true object was to benefit the settlor who is an excluded person. Provided the trustees make clear that they would be prepared to vary the Debt Trust even if the adult children do not later request a write off then Step 1 above should be valid. Step 2 should not be taken until the children have taken independent advice.

(b) The release avoids an income tax charge on the interest accrued to date.

(c) The release of the RDS means that there is no liability affecting the property with the result that Sch.15 no longer applies (para.11(1)).

(d) Any past POAT can be refunded. No further POAT is payable even if the scheme is wound up half way through the tax year.

(e) Once the release is effected, the property will be fully eligible for the spouse exemption on the death of the settlor and any other "normal" inheritance tax saving measures.

(f) The children make a PET resulting in the termination of their qualifying interests in possession equal to their share in the value of the debt.

(g) If the Property Trust continues, ensure the property passes to the children outright on the settlor's death to secure any available residence nil rate band relief. Otherwise it is not "closely inherited."

Loans can be written off under the above route even if not an RDS but in these circumstances the write off will be a disposal for CGT purposes and trigger tax on the gain unless the trustee of Trust 2 holding the loan is the original creditor. Unless the loan was repayable on demand

the loan is likely to show a significant increase in value from the original discounted value when assigned to the trustees and now.

47.515 What happens if the settlor failed to survive seven years from the date of the original gift? Originally there was a risk of a double charge to inheritance tax on the value of the property where the debt was released rather than assigned back to the settlor. However, double charges relief became available under the 2005 Inheritance Tax Regulations[36] SI 2005/341. Set out in Vol.3, Pt 2. if the original donor died within seven years of the gift of the debt and the following conditions were satisfied:

(a) the disposal or contribution condition is satisfied and the donor has made a transfer of value as a result of which a third party becomes entitled to the benefit of the debt owed to the deceased;

(b) before the donor has died the debt is wholly written off or released;

(c) the donor dies on or after 6 April 2005;

(d) on the donor's death, the house (or substitute property) is included in the donor's estate.

The Regulations calculate (i) the inheritance tax due on the donor's death ignoring the gift of the debt and (ii) the inheritance tax due on the donor's death including the PET but ignoring the value of the house. The higher charge is taken.

A enters into a home loan scheme. He sells his house to the trustees of Trust 1 for £1 million, which is left outstanding as a debt that *A* gives away to his children in 2003 but since it is only repayable on his death the commercial value is £800,000. In 2005 the children write off the debt. He dies in 2007 when the house is worth £1.4 million leaving everything to his spouse. HMRC will tax the PET of £800,000. If his spouse later dies the house is chargeable in full.

However, if A had left his house to a discretionary trust with his spouse remaining in occupation then HMRC would have taxed the house on his death but ignored the gift of the debt. On the spouse's death no further tax would have been payable.

The regulations only give relief if the entire outstanding debt is written off. Partial releases are not sufficient. The regulations are largely of historic interest now that more than seven years has elapsed since the schemes were done.

SDLT on the creation of a non-recourse charge

47.515A Can SDLT can be avoided if the house transferred back to the parents is first burdened with a non-recourse charge? The position is debateable.[37] Note that most home loan schemes were carried out before December 2003 with the sale left resting on contract so as to avoid stamp duty. On subsequent completion of the sale in favour of the trustees generally stamp duty rather than SDLT is payable. More usually no completion of the sale takes place and instead when the property is sold to a third party the legal owner (the settlor) conveys it at the direction of the trustees to that third party. SDLT is then payable by the third party but not the trustees. It is clear that if the settlors take on any liability for the debt then SDLT will arise as that is consideration for the transfer to them.[38] FA 2003 Sch.4 para.8. In addition, para.8(1A) provides that where:

"

(a) debt is secured on the subject-matter of a land transaction immediately before and immediately after the transaction, and

(b) the rights or liabilities in relation to that debt of any party to the transaction are changed as a result of or in connection with the transaction,

then ... there is an assumption of that debt by the purchaser ...
"

The non-recourse agreement between the two trustees provides for an equitable charge over the house in favour of the Debt Trustees, and that the Property Trustees will be "*under no further or personal liability to ensure that the sums due are paid to the Creditors who accept that their only recourse in respect of such sums due is now against the Property by enforcement of their equitable charge.*" Hence, the Property Trustees will have no personal responsibility to repay the debt. There is now an equitable charge over the property and the consent of the Debt Trustees will not be required to the distribution of the property. Hence, it is thought that there is a change to the rights of the Debt Trustees but they are not parties to the land transaction (the appointment to the settlor).

It might be argued that such an agreement and charge *does* change the liabilities of the Property Trustees in relation to the debt since before the Charge they may not have been able to appoint the property out to the parents without the consent of the Debt Trustees and/or under this route they are no longer personally liable for the debt; therefore if it is made in contemplation of the subsequent transfer to the parents there is an SDLT charge on transfer to the parents.[39] It is rare for home loan schemes expressly to restrict the personal liability of the Property Trustees to the value of the house. In practice given that HMRC now allow the loan to be written off rather than transferred, SDLT is unlikely to be a problem.

Option 3: Election

47.516 This is the route the Government has offered as a way of avoiding the POA income tax charge. However, despite Government assurances, the effect of the election is far from clear.[40] *See* 47.600 et seq.

Option 4: Pay rent under a legal obligation by a deed of covenant

47.517 The taxpayer uses the let-out in Sch.15 para.4(1) and makes payments under a legal obligation equal to the appropriate rental value in respect of his occupation. Note that the legislation does not refer to payment of *rent* as such. The taxpayer could therefore enter into a deed of covenant and agree to pay to the property trustees a sum equal to the market rent of the property for so long as he remains in occupation. The sums paid do not suffer income tax in the hands of the recipient trustees. Otherwise the structure remains unchanged.

In connection with this arrangement note:

(a) that it is considered that payments under the deed are not rent: they are voluntary payments outside the income tax net[41] *See* ITTOIA 2005 s.727. ;

(b) because the payments are to the Property Trust in which the payer has a life interest prior to 22 March 2006, there was no transfer of value for IHT purposes. After that date such payments made under any new covenant are chargeable transfers unless they can be paid out

of surplus income in which case they are exempt[42] *See* IHTA 1984 s.21. ; however, they form relevant property and as they are being paid to the Property Trust they are also subject to reservation of benefit on the settlor's death as well as ten-year and exit charges.

(c) if the payments are not consideration for the occupation of the property (i.e. rent) CGT principal private residence relief will not be affected.[43] *See* generally *Sansom v Peay* [1976] 3 All E.R. 375.

Option 5: Reverter to settlor trust (before 22 March 2006)

47.518 This involved reorganising the Property Trust in an attempt to preserve the inheritance tax savings but to avoid an income tax charge. The use of this arrangement to avoid a POAT charge was arguably stopped by FA 2006 s.80, although the position is not free from all doubt in some cases (*see below*). However, even if such planning still works for POAT purposes if done after 22 March 2006, it will now involve immediate chargeable transfers for inheritance tax purposes.

The restructuring could be complex but essentially involved the following:

1. The settlor surrendered his life interest in the Property Trust to his children so they became entitled to qualifying interests in possession. He was excluded as a beneficiary of the Property Trust; he paid a market rent for his continued occupation.
2. The Children's Trust then appointed the benefit of the debt (owed to it by the Property Trust) to the Property Trust which now had the same beneficiaries. Alternatively, the Children's Trust wrote off the debt.
3. Subsequently, the Property Trust appointed the house to the children absolutely (the house of course was free of debt and so SDLT was not in point).
4. The children then resettled the house (free of debt) on a new trust being a reverter to settlor trust for the parent settlor under which he took a qualifying interest in possession.[44] It will be appreciated that this restructuring could only be contemplated if the children were adult and were independently advised. The idea was to ensure that the ownership exemption in para.11(1) was available to protect the settlor from a POA charge.

47.519 Note the following.

1. If a child died within seven years of settling the house into the new Trust his failed PET became chargeable.[45] Note the general advantage and pitfalls of reverter to settlor trusts in Ch.48.
2. The new structure was vulnerable to legislative changes. These came in the form of an announcement that with effect from 5 December 2005 where property had ceased to be comprised in the settlor's estate and then became comprised in it again by being settled on a qualifying interest in possession trust the settlor was not protected from a POA charge. The ownership exemption was in effect disapplied. This change was enacted in FA 2006 s.80 and is discussed in Chs 37, 38 and 41. However, curiously s.80 would appear not to catch those reverter to settlor trusts where the house remained held on interest in possession trusts for the settlor throughout and the trustees of Trust 2 simply advanced the loan to the children who then resettled it on reverter to settlor trusts for the settlor prior to March 2006. In these circumstances the excluded liability continues but no longer reduces the value of the settlor's estate given that under the reverter to settlor trust the loan forms part of his estate. The relevant property held on reverter to settlor trusts is not the house but the loan and the loan may not have been part of the settlor's estate at all if he did not assign the loan to Trust 2 in 2003. Hence the ownership exemption is not disapplied under s.80.

3. The new reverter to settlor trust could only hold the house or other real estate rather than cash or equities, otherwise the children faced a POA charge. Children could not occupy the house.
4. HMRC might challenge the arrangement on the basis that it involves unacceptable tax avoidance, was circular and the children were not really the settlors.
5. The appointment of an RDS to the Property Trust or to the children was likely to cause income tax problems if it showed a profit.

As noted above, such reverter to settlor arrangements are not possible after 21 March 2006 as a result of the inheritance tax changes.

Option 6: Reorganise the Property Trust (before 6 October 2008)

47.520 A less radical option was to restructure the Property Trust alone. The Trustees would terminate the settlor's interest in say 75 per cent of the Trust Fund which then became held on revocable qualifying interest in possession trusts for settlor's children. (Again this planning was not feasible once the period for creating transitional serial interests had expired on 5 October 2008.) The appointment in favour of the children was revocable. The settlor was not wholly excluded from future benefit.

Full CGT principal private residence relief continues to be available on the basis of the settlor's occupation of the property as a beneficiary of the trust.

The POA charge applies to the settlor but only on that portion of the rental value attributable to his interest retained and with the possibility of limiting the size of the share so that the benefit falls within the £5,000 de minimis exemption.

On the 75 per cent share now held for the children, it is arguable that a benefit has been reserved by the settlor and so under Sch.15 para.11(3) the POA charge is inapplicable. Reserved benefit property is not affected by the "excluded liability" provisions which do not apply to para.11(3). Hence the POA charge does not apply on the 75 per cent share.[46] This of course involves applying the reservation of benefit let-out to part only of the relevant property. It also involves apportioning the excluded liability between the retained and appointed funds.

47.521 The above analysis depends on the settlor being treated as having reserved a benefit in the 75 per cent share. On the settlor's death what happens? The reservation of benefit rules treat the settlor as beneficially entitled to the property at that time. Nothing is included in the legislation to deal with the valuation of that property and it is therefore thought that general principles will apply and that it is only the net value of the property which is included in his estate.[47] *See* further in the context of the election, 47.601.

47.522 Bear in mind that the children enjoy interests in possession in 75 per cent of the property and in general terms have a right to occupy it.[48] *See* TLATA 1996 s.12. Of course they may not exercise that right and it is not thought in such a case that the settlor would be treated as having an interest in possession in the entirety. Of course the position would be strengthened if the settlor made a "compensating payment" to the children to reflect his sole occupancy.[49] *See* TLATA 1996 s.13. This would be sensible: the settlor does not want to be treated as having an interest in possession in the whole because otherwise he suffers a POA charge on the whole Trust Fund.

Option 7: Change the nature of the settled property

47.523 If the settlor ceases to occupy the house, e.g. it is let or the property is sold and the trustees then hold intangibles, no POA charge should arise. The para.4 charge on land does not apply to let property and the para.9 charge on intangibles should not apply to home loan schemes, given that the relevant property has not been "settled".[50] *See* 36.111.

MAKING THE ELECTION

47.600 The mechanics involved in the making of an election have been considered in Ch.41. In the case of home loan schemes a key matter to bear in mind is the time limit: for a scheme in existence on April 6 2005 which is within the POA charge, the deadline was 31 January 2007 (subject to the point made in Ch.41 that the necessary regulation had not been passed[51] *See* 41.113.). After that date HMRC consider that it will not be possible to elect although as explained in Ch.41 the editors consider that a later election is not only possible but necessary to be valid. The effects of making the election are considered below but the intention behind the legislation is clear: by electing the taxpayer should bring himself within the IHT reservation of benefit rules so that on his death the property occupied will be taxed as part of his estate.

Does the s.102(3) condition apply?

47.601 The legislation[52] FA 2004 Sch.15 para.21(2)(b). provides as follows:

(a) if an election is made the POA Regime shall not apply;

(b) s.102(3) and (4) of FA 1986 shall apply;

(c) s.102(3) deals with the situation where on the death of the taxpayer there is property in which he has reserved a benefit and provides that, for the purposes of the IHT charge, the taxpayer is to be treated as beneficially entitled to that property immediately before his death; and

(d) however, s.102(3) only applies to the extent that the property "would not, apart from this section, form part of the donor's estate immediately before his death".[53] Curiously this limitation on the operation of s.102(3) is not included in s.102(4), which imposes a deemed PET when a reservation ceases inter vivos.

47.602 When the election is made and s.102(3) applies does the restriction continue to apply, i.e. where the taxpayer makes the election can his executors in due course successfully argue that because he had a qualifying interest in possession the property already formed part of his estate at death so that a charge to IHT will not arise under the reservation of benefit rules? The wording in s.102(3) does not impose any restriction for excluded liabilities.

The first argument is as follows.

47.603 The draftsman has throughout the POAT Regime expressly adopted the IHT legislation. Where an election is made, the legislation simply provides, without stating anything more, that the property in question (i.e. the land) is to be treated as property subject to a reservation and ss.102(3) and 102(4) are to apply. Had it been intended that s.102(3) were to be read as though important words had been excised from it, one would have expected the draftsman to provide as much. In the absence of express provision, it is hard to justify applying s.102(3) one way under the normal rules and another way when the taxpayer elects for it to apply under the Regime. On that basis making an election has no adverse inheritance tax effect.

47.604 The counter-argument for HMRC was as follows:

(a) para.21(2)(b) provides that, if the election is made, the chargeable proportion of the property is to be treated as property subject to a reservation; and

(b) s.102(3) shall apply.

In any event, the amendments made in FA 2006 s.80 (to stop reverter to settlor schemes) expressly state that the chargeable proportion of the property is to be treated as property subject to a reservation of benefit and s.102(3) shall *apply but only so far as the chargeable person is not beneficially entitled to an interest in possession*. On that basis, the additional words in italics seem to reinforce the argument above that making an election has no adverse effect for inheritance tax purposes because the reservation of benefit provisions are disapplied by s.102(3) and the taxpayer is simply treated as holding an interest in possession in the property with a deduction for the debt.

47.605 The IHT 500 form hardly helps because it refers to an election in respect of the land—there is no suggestion that the election is in respect of the debt itself which would make more sense in the context of home loan schemes.[54] *See* further 41.122.

What value is included in the taxpayer's estate if s.102(3) applies?

47.606 A further problem in considering the effects of the election is as follows: s.102(3) provides that the taxpayer is to be treated as beneficially entitled to the property in which he has reserved a benefit immediately before his death. Nothing is said about how that property is to be valued but presumably normal IHT principles apply.[55] The wording used is similar to that in IHTA 1984 s.49 which treats an interest in possession beneficiary as being "beneficially entitled to the property in which the interest subsists". Again nothing is said expressly about liabilities but in practice they have always been allowed so that the net value of the trust fund is taxed. This was accepted as correct in *St Barbe Green v IRC* [2005] S.T.C. 288. It is therefore thought that liabilities affecting the property (e.g. the debt owed by the trustees of Trust 1) fall to be deducted and it is only the net value which falls into the IHT net. In practice this may result in a relatively small value being clawed into the IHT net.[56] HMRC considers that personal liabilities of the taxpayer cannot be offset against the value of reservation of benefit property. The point discussed in the text is quite different and goes to the question of how to value the reservation property. This argument would be strengthened if the property were to be made subject to an express charge for the amount owed (IHTA 1984 s.162(4): "a liability which is an incumbrance on property shall, so far as possible, be taken to reduce the value of that property").

Summary

47.607 There are two arguments that the election protects the chargeable person from a POA charge but has no adverse effect for inheritance tax purposes. The first is that the taxpayer continues to be treated as holding a qualifying interest in possession in the house, the reservation of benefit provisions are therefore disapplied, and the debt is still deductible. Alternatively the taxpayer is treated as reserving a benefit in the home but the debt is deductible against that reserved benefit property. Neither of these arguments is accepted by HMRC.

If either analysis is right it may be concluded that there is no IHT cost in making the election. If HMRC are right and there is a GWR, a deemed PET would technically occur if the settlor(s) ceased to benefit from the settled property during his lifetime, e.g. if his interest in possession

was ended and he moved out of the property. The debt would in the editors' view still be deductible, althought HMRC do not accept this.

Double charges relief

47.608 Under the original terms of Sch.15 the election could result in double tax. This was because the gift of the debt to the Children's Trust was a PET and yet the election resulted in the full value of the property (without deduction for the debt) being in the estate of the settlor.[57] This, of course, assumes that the defects identified above in connection with the election are wrong. This potential double charge was addressed by reg.6 of SI 2005/724.[58] *See* further Ch.42 where the regulation is considered in detail.

Further considerations flowing from the election

47.609 There is a question mark over whether the spouse exemption will apply to the extent of the debt or only the net value of the property will attract the spouse exemption. The editors consider that full spouse exemption should be available on the basis that the deceased's share in the house becomes comprised in the survivor's estate as IHTA 1984 s.18 requires. This is so even if the value of the debt equals or exceeds that of the house. If this is wrong then the effect of the election for married couples is that there will be an accelerated inheritance tax charge on the death of the first rather than the last spouse.[59] For HMRC's view on the availability of the exemption, *see* Vol.3 Pt 5.8. In fact HMRC take the latter view.

47.610 An election can only be made if tax under Sch.15 is otherwise chargeable. This, inter alia, precludes an election if the notional rent attributed to the settlor is less than £5,000 per year. It also precludes election if in fact no income tax is due because the POA Regime does not apply to home loan schemes anyway.

47.611 If an election is made it cannot be revoked after the deadline for an enquiry into the tax return has ended or the death of the settlor if earlier.

47.612 If an election is made, bear in mind that the children still have the debt in their estates. The result is that the children may suffer an inheritance tax charge if they die. This is, of course, the normal result of the GWR legislation.[60] *See* 32.215. In addition CGT could be payable on the repayment of the debt.

Property schemes today

47.613 Old style home loan schemes in respect of the taxpayer's dwelling house will not be entered into today in the same form as previously for the following reasons:

(a) the pre-owned assets charge;

(b) the SDLT charge on a sale of the property;

(c) the 2006 changes to the inheritance tax treatment of trusts mean that the loan cannot be assigned to an IIP trust;

(d) HMRC do not accept the scheme works and are litigating the point (as at March 2017).

(e) changes introduced in the Finance Act 2013 mean that in order to be deductible the loan must be repaid on death. See IHTA s.175A. This means that it will now be difficult to avoid an income tax or CGT charge on the loan when repaid. The original idea had been to claim an IHT deduction for the loan but then write off the interest or loan. That option will no longer work. Therefore any IHT savings are reduced by the CGT or income tax payable on repayment of the loan.

(f) Finally the introduction of residence nil rate band means that many people feel these sorts of scheme are unnecessary as up to £1 million of an estate can eventually be protected from IHT in a joint life situation.

OPTIONS FOR TAXPAYERS

What should taxpayers of existing home loan schemes do?

47.614 Given that HMRC will not accept home loan schemes "work" for IHT purposes what should taxpayers do? If taxpayers wish to litigate then they may want to stand behind the test case going forward in 2019 and in the meantime make a payment on account without prejudice to an eventual refund if the taxpayer in the test case is successful (see August 2012 Newsletter cited above). Note that otherwise there is a four year time limit for repayments. Generally, unless the taxpayer's family is prepared to litigate on his death (or wait until the existing case being taken is resolved through the courts), or the taxpayer has already suffered an income tax enquiry into his POAT payments (in which case the scheme should be preserved as HMRC may accept the IHT deduction of the debt on the settlor's death), consideration should be given to whether the scheme can now be wound up. This is particularly the case if the settlor is downsizing anyway and prepared to repay the loan or give away some of the house sale proceeds. The residence nil rate band may help to reduce the IHT on the death of the settlor.

At least if the scheme is wound up the settlor can reclaim POAT and cut his losses. Now that HMRC accept a write off a debt is not a chargeable transfer the options for winding these schemes up become a little easier.

If the home loan scheme is not wound up, practitioners should ensure that the Property Trust is changed so that on the settlor's death the house passes outright to the issue. Then they "closely inherit". There must be no continuing trusts. Then residence nil rate band can be claimed if available. To avoid continuing trusts after the settlor's death it is likely that the trustees' overriding powers will have to be limited so that they are no longer exercisable after the settlor's death.

Where the scheme cannot be wound up before the first spouse to die (e.g. because the children do not agree or the CGT on the loan write off is too high) then if IHT is paid on the first spouse's death on the basis that the trustees accept the scheme does not work, that half share of the house taken by the deceased spouse should then be kept ringfenced in the trust as it is protected from IHT going forward on the second spouse's death. It should not be given away, spent or appointed outright to the surviving spouse but instead retained in the Property Trust for the benefit of the surviving spouse who will continue to have a life interest. All the POAT can be refunded to both surviving and deceased spouses. See Example 47.3 above.

SUMMARY OF HOME LOAN SCHEME OPTIONS

Options	Advantages	Disadvantages
Option 1: Unscramble non-RDS scheme Debt Trust assigns debt to children contingent on surviving 21 days and children assign remainder interest to settlor. No further POAT once excluded liability comprised in settlor's estate. Property Trust advance the property out to the settlor(s) subject to the debt but without the settlor taking on any liability.	. Settlors back in original tax position but only after seven years from date of original scheme. Original PET may become chargeable but double charges relief available. . No POA income tax charge once debt in settlor's estate compliance issues, etc avoided. Full POAT refund on past payments. . Certainty going forward. Spouse exemption on first death	. IHT savings lost but IHT planning may still be possible. . Children must be adult and agree. . Care needed to avoid SDLT. . Possible capital gains tax issues on assignment of debt if it shows a gain.
Option 1A: unscramble RDS scheme Debt Trust made for benefit of adult children only Children direct Trustees to write off debt	. No income tax . IHT savings lost but only PET by children and no PET by settlor . POAT refunded . Certainty going forward. Spouse exemption on first death	. IHT savings lost Planning may still be possible . Better SDLT position . Can be done on any loan but will then have CGT on write off
Option 2: Pay income tax/do nothing	. IHT savings preserved but likely to be challenged on first death. No spouse exemption on debt element. . Taxable benefit may be within de minimis exemption. Otherwise income tax payable unless taxpayer takes view that debt does not cause POA problem because not an excluded liability or is fully protected as a non-exempt sale. May lose any possibility of POAT refund. . No disturbance to current structure. . Taxpayer may die, become non-resident or move out in which case no need to argue point anyway, i.e. family circumstances may change. Trustees may sell house.	. Compliance issues on valuation but only every five years. . Election time limit missed unless de minimis excludes benefit from charge. . May end up with no IHT savings and income tax payable if HMRC successfully argue reservation of benefit, although POAT will be refunded. No spouse exemption on first death. . Annual income tax charge may erode IHT savings. . Residence nil rate band makes the scheme look less worthwhile. . Likely to have to wait for litigation to win the case.

Options	Advantages	Disadvantages
	. Defers decision until more information is available and there may be further changes in legislation. Future action can still be taken. However, position unlikely to be improve and may be better to cut losses. . Settlor may become non–resident later or die. Preserves flexibility in IHT planning.	Uncertainty. Debt is part of donee’s estate.
Option 2B: Do nothing until first spouse’s death and then write off loan and accept the loan is not deductible for IHT purposes so tax paid on first spouse’s death.	. IHT exemption on deceased’s share going forward on second spouse’s death and this covers even future increases in value on that half share of the deceased’s part. Surviving spouse can still enjoy the income of that share. . Full refund of POAT. . RNRB and the NRB of the surviving spouse may protect the remaining half share from IHT on the second spouse’s death.	. IHT payable on the first death and therefore accelerated. However, NRB of first spouse may cover much of the value charged and mean the IHT payable is small overall. . Still have to deal with CGT on the loan element if it is written off and it is not an RDS.
Option 3: Election	. No POAT. . IHT savings arguably preserved due to defective legislation. . No continuing compliance issues once election made. . No double charge if death within seven years.	. Fiscal uncertainties, e.g. as to whether spouse exemption available on first death of married couple. . Defective legislation may eventually be corrected by Revenue and IHT savings lost. . Structure remains in place with debt still outstanding. Scheme not unravelled. Future IHT planning options very restricted. . Debt remains part of donee’s estate for inheritance tax purposes.

Options	Advantages	Disadvantages
Option 4: Move out and let/sell home or go non-resident	. Preserves IHT position. . No further POA. . Sensible if parents have another home or intend to move abroad soon. No major legal restructuring required.	. Major disruption to lifestyle. . Settlor pays tax on rent received if home let and income from securities. . No point if settlor has to rent elsewhere. . Restriction on principal private residence relief after 18 months of absence. . Still uncertainty over whether scheme works.
Option 5: Settlor enters into deed of covenant agreeing to pay property trustees fixed sum for his occupation under legal obligation for as long as he occupies	. No POA. . IHT savings preserved. . Arguably no income tax on payments under deed of covenant. . No major restructuring required.	. Compliance—disclosure, valuations needed. . Payments under covenant must actually be made and may be taxable as rent. However, after expenses this may be less than paying the POA income tax. . Covenant payments are chargeable transfers after 21 March 2006 (unless exempt as normal expenditure). Settlor reserves a benefit. 10-year anniversary charge. Fall into the relevant property regime
Option 6: Reorganise property trust Parent settlors reserve benefit and trustees appoint revocable interest in possession trust to children as to (say) 75 per cent subject to charge in favour of family trust. Home still held in one trust. Debt remains in Family Trust.	. POA payable only on 25 per cent. . IHT savings may be preserved. . Parents can benefit from 75 per cent fund in future if needed. . CGT principal private residence relief preserved.	. Parents may be treated as having interest in possession in whole and therefore POA not saved. . Technical IHT analysis difficult— parents have reserved a benefit but value of what they have reserved is still reduced by the charge. Not possible to do after 5 October 2008 because children cannot take qualifying interests in possession. . Difficult if married couple. No spouse exemption so

Options	Advantages	Disadvantages
		IHT on first death if deduction argument wrong. . Current debt structure remains in place. . Compliance issues on valuation of 25 per cent in parents' estates—continuing POA valuation every five years needed.

HOME LOAN VARIANTS

The family debt scheme

47.801 Typical of more aggressive planning is the following arrangement, a variant of the home loan scheme, between spouses.

Tobias owns a private investment company, the shares of which show a large unrealised capital gain. Ultimately he intends to give the shares to his children and grandchildren but for the present wishes to continue to run the business; retain the company dividends while getting the value of the shares out of his estate.

He therefore sells the shares at market value to his wife Ruth with the purchase price being left outstanding as a debt owed by Ruth, which is repayable on the last of them to die. Tobias gives the benefit of the debt to his children/grandchildren.

The tax consequences are:

1. stamp duty is payable by Ruth on the price payable for the purchase of the shares[61] The family debt scheme can be used for any type of property (including the family home) but bear in mind that SDLT is now payable at a top rate of 7 per cent. Stamp duty on a sale of the shares is at a rate of only 0.5 per cent. ;
2. there is no CGT payable by Tobias on the disposal of the shares because under TCGA 1992 s.58 the sale to his spouse is treated as taking place at no gain no loss;
3. generally the POAT regime does not apply because the transfer is to a spouse (the fact it is a sale not a gift does not matter). A further reason for the Regime not applying is because the charge on intangible property (such as shares) only applies if the property is settled;
4. for IHT purposes, the sale to Ruth is a non-event. Even if it is at an undervalue, the gift element is spouse exempt (assuming that she is UK domiciled or, if necessary, elects to be domiciled) and so is outside reservation of benefit (FA 1986 s.102(5)). The properties are part of Ruth's estate but subject to a debt in favour of the children/grandchildren.[62] It is of course critical that the debt is deductible on Ruth's death and hence FA 1986 s.103 needs to be born in mind. On Ruth's death the properties can pass to Tobias if he is still alive subject to the debt. On the last of Tobias and Ruth to die, the debt is repayable. Tobias has made a PET of the debt; provided that he survives seven years there is no inheritance tax on the gift. In any event, there may be a discount on the value of the PET of the debt given that it is not repayable until the death of Tobias and Ruth;

5. there may be capital gains tax or income tax repercussions on the eventual repayment of the debt, depending on how it is structured;
6. any dividends arising from the shares is paid to Ruth but may be taxed as Tobias' under the settlement provisions.

A variant of this scheme would involve a sale of the family home by Tobias to Ruth. Although the property continues to be occupied by Tobias, the transfer to Ruth is an excluded transaction for POA purposes[63] FA 2004 Sch.15 para.10(1)(b). and outside reservation of benefit.[64] FA 1986 s.102(5). The scheme can also be adapted for other assets such as equities pregnant with gain or commercial properties.

The debt must be given outright to the children or grandchildren (not settled) in order to avoid an immediately chargeable transfer for IHT purposes. On the other hand if the parents are worried about the children divorcing and the loan being an asset of their estates, they can take some comfort in the fact that until the last of Tobias and Ruth to die, the debt cannot be called in. Because of FA 1986 s.103, the scheme cannot be used where there have been gifts by the purchasing spouse to the other. Similarly, take care where the asset being sold to one spouse is jointly owned: it is important that the house or other property is not sold for more than its market value otherwise the debt will not be deductible to the extent of the excess. It is also important to ensure that if Ruth dies first and the assets pass back to Tobias subject to the debt that does not involve Tobias taking on any personal liability since otherwise s.103 will apply and a deduction will not be available on his death.

In practice a major issue is to decide the terms of the debt owed by Ruth. Given HMRC's views on the scope of reservation of benefit it should not be repayable on demand but (say) only after the death of Ruth and Tobias. But should it carry interest and/or be index-linked? For simplicity neither[65] This avoids income tax on the interest when paid (and HMRC may claim that any increase due to indexation is interest) and also problems later if the scheme has to be dismantled, e.g. on the divorce of the spouses. which will mean:

(i) that the value of the PET of the debt is substantially discounted;

(ii) that the base cost of the debt in the hands of the children/grandchildren will be correspondingly low so giving rise to the risk of a substantial CGT charge if it is a chargeable asset;

(iii) that the gift is of the current value of the shares. If it is desired to deal with future increases in value then consider combining a share freezer[66] Typically this will first involve issuing bonus growth shares and freezing the value of the existing shares. scheme with the family debt arrangement.

Note that there may also be issues regarding the validity of the loan if interest is charged. The licensing of consumer credit lending has since 1 April 2014 been governed by the Financial Services and Markets Act 2000 (FSMA) rather than the Consumer Credit Act 1974. Section 19 of the FSMA provides that no person may carry on a regulated activity in the UK unless he is an authorised person or an exempt person. Under s.22 of FSMA, an activity is only a regulated activity if it is carried on by way of business. Alternatively even if not a regulated mortgage, the loan could amount to a credit agreement within the Regulated Activities Order 2001 art.60B. If the requirements of the legislation were not followed, the loan would be unenforceable. These questions do not arise in the first place if the loan is not provided "by way of business". Determining whether a loan is provided in the course of business involves a question of judgment which will likely engage factors such as: (i) the degree of continuity,

(ii) the existence of a commercial element such as interest, (iii) the scale of the activity, (iv) overall context.

It is unlikely that an uncommercial loan made in a personal capacity from parents to a trust or to issue would be found by the FCA or an English court to be an activity carried on by way of business.

A spoiler warning

47.802 The family debt scheme involves aggressive (some would say artificial) IHT planning and is precisely the sort of arrangement that successive governments have sought to prevent. It is closely related to the home loan scheme on which the Revenue's views have significantly changed. The "new approach" is that none of these schemes work and HMRC have advanced a number of arguments as to why this is so. Some of these have no application to the family debt scheme (since they are concerned with the trusts used in the home loan scheme which are not replicated in the family debt scheme) but it is to be expected that, in the current climate, the family debt scheme will be challenged when HMRC have a suitable case, presumably primarily on the basis that there is a ROB in the loan. This is therefore planning for the brave. Furthermore, given the new IHT disclosure rules in force from 1 April 2018 such planning surely is a reportable scheme. See Chapter 1.