HOME LOANS

AN UPDATE ON COMMON INHERITANCE TAX MITIGATION SCHEMES

BY EMMA CHAMBERLAIN

Home loan or double-trust schemes proliferated in the decade ending 1 December 2003. With the introduction of the pre-owned assets income tax charge (POAT) on 6 April 2005, HMRC had to form a view on whether the arrangements, if properly implemented, succeeded in their goal of reducing the inheritance tax (IHT) charge on the taxpayer's main residence, provided that they survived for seven years (with some savings if they survived three). If the schemes did reduce IHT, POAT would generally be payable.

The structure of a typical home loan scheme

Step 1: A settlor (S) set up a life-interest trust (Trust 1: the property trust), under the terms of which they were a life tenant with the right to enjoy the income of the trust and the use of the trust property. The trustees were given the usual modern flexible powers, e.g. to advance capital to S or to terminate S's life interest. The remainder beneficiaries were S's family.

Step 2: S set up a second (generally) qualifying pre-2006 interest in possession trust (Trust 2: the debt trust) for the benefit of their children. S was wholly excluded from benefit under this trust.

Step 3: S sold their house to the trustees of the property trust, leaving the purchase price outstanding as a loan.

Step 4: S gifted the benefit of the debt into the debt trust (a potentially exempt transfer (PET) by S).

On S's death it was thought that the position was as follows:

- S enjoyed a life interest in the property trust and so was subject to IHT on the house (s49(1) of the *Inheritance Tax Act (IHTA) 1984*). On these facts, and assuming no increase in the value of the property, because the debt would reduce the value of the house to nil, the net value of the property subject to IHT was nil.
- Provided that S survived for seven years, the PET of the debt became an exempt transfer; even if S died, there was often a substantial discount if the debt was structured so as not to be repayable until S's death, since the value of the debt gifted was then generally less than its face value.

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

- In some cases it was interest-free and repayable on demand.
- In others it was interest-free but repayable after the death of S.
- Sometimes interest was payable and rolled up with the principal; in other cases the debt was indexed (e.g. by reference to the Retail Prices Index or to a property index).
- 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 when S died.
- One arrangement involved the use of a tripartite loan agreement between S and the two sets of trustees, avoiding the necessity for a separate assignment of the debt by S. This was thought to avoid capital gains tax problems on repayment of the debt to debt trust (given that the trustees of the debt trust would not otherwise be the original creditor of the trust) (s251(1) of the *Taxation of Chargeable Gains Act 1992*).

HMRC's approach to home loan schemes

HMRC has now seen a significant number of home loan schemes. Its initial approach was published in the POA guidance notes in 2005, which stated its views as follows:

a) Where the loan was repayable on demand because the trustees had not called in the loan, it had conferred a significant benefit on the taxpayer in enabling them 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) 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'.

Accordingly, taxpayers in some cases opted to pay the POAT charge in the belief that the IHT savings would be secure.

However, in October 2010, the guidance was revised by the inclusion of the following sentence:

'HMRC is now of the view that these schemes... [i.e. gifts where the loan is not repayable on demand] are also caught as gifts with reservation. Further guidance, including the consequences for the POA charge, will be issued shortly.'

In 2011 HMRC reissued the POAT guidance. This said:

'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 *W T Ramsay* v *IRC* [1981] 1 All ER 865. The composite transaction has the effect that the vendor has made a "gift" of the property concerned for the purposes of [s102 of the *Finance Act* (FA) *1986*] 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.'

IHT litigation

HMRC now considers that any home loan scheme fails to mitigate IHT for four reasons:

1. Section 103 FA 1986 applies, with the result that the loan is not a valid deduction against the trust fund of the property trust.
2. The *Ramsay* principle applies, so the gift is to be recharacterised as 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 there is a reservation of benefit in the loan.
4. In any event, if the loan is repayable on demand, on basic principles alone it is subject to reservation of benefit.

HMRC therefore argues different grounds. Its first says there is a disallowance of the debt in the hands of the trustees; its second that there is a reservation of benefit in the house and no deduction for the debt, and its last two claim there is a reservation of benefit in the loan note held by the debt trust. The IHT consequences will depend partly on the grounds on which HMRC succeeds, if any.

In correspondence, HMRC presents the argument on disallowance of debts under s103 FA 1986 as follows:

1. Section 103 is 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 s103.
2. While the loan may not have been secured on the property, it has given rise to an equitable lien in favour of the trustees against the property in respect of their indebtedness to the deceased.
3. That lien is then an encumbrance, brought into being or created by the disposition.

Against the HMRC view, it is not clear that the trustees' lien is an encumbrance within the meaning of s103. Even if it is, the encumbrance was not itself created by the sale of the property: rather it arose out of the rights of reimbursement that trustees always have against the trust fund in respect of their liabilities, and the property sold to the trustees was not consideration for any encumbrance – it was consideration for the debt. *Green and another* v *CIR* [2005] EWHC 14 (Ch) outlines how the trust property should be valued for IHT purposes and clearly takes account of any trust lien, whether or not the debt is secured.

The settlor does not have any direct lien; it is the trustees who have the lien, and in these circumstances s103 does not seem apposite.

HMRC's *Ramsay* point seems misconceived. It says: '... 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.'

The assertion that a sale of a house is a gift of the house where the proceeds are given away is striking. There is no basis under *Ramsay* for recharacterising a gift of a debt as a gift of a house, particularly where the house remains in a separate trust and the money is still owed to the debt trust. This suggests that the transactions are shams, but there is no suggestion that the debt does not exist or can be ignored. Moreover, even if there is a potential reservation of benefit in the property trust, given that there is a qualifying interest in possession in the whole settled property, s102(3) FA 1986 would appear to disapply the reservation of benefit provisions. HMRC argues that the settlor's interest in possession is in the net value of the property only, and that the settlor reserves a benefit in the debt element, but this cannot be right: the interest in possession would then fluctuate depending on how much the debt increased or decreased from time to time. Non-qualifying interests in possession would then arise each time a loan was paid off after 22 March 2006.

HMRC argues that the scheme is caught by associated operations because, after the disposal to the trust, the donor was no longer the owner of the house but could still, as beneficiary

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of the property trust, occupy the property. By making the loan repayable only after the settlor's death, the settlor ensured that their continued occupation would not be disturbed. HMRC says that is 'plainly' a benefit to the settlor 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 s102(1)(b).'

Even though the gift and prior sale are associated operations within s268 IHTA 1984, it remains difficult to see how the settlor has benefited from the loan note. Specifically, there is nothing in the legislation to require an extended meaning to be given in determining 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, even though the nature of the gift meant that the freeholder had to allow the donor to continue living in the property. In this case what is being given away is a debt made on certain terms and subject to certain rights. It is not the gift of the debt that enables the donor to continue living in the property. Moreover, even if the terms of the debt are such that the donor can occupy the property, it is not the gift itself that does it; the case law states that the donor is allowed to divide their cake into slices and keep part and give away the balance. The donor can live in the house because they have an interest in possession in the property trust. Whether or not they give away the debt, their rights of occupation remain the same.

Faced with the above attack, the settlor of a home loan scheme who has not yet died has three options:

Option 1: release of debt
This is difficult because, if the debt trust writes off or releases the debt, this would be a breach of trust unless the settlor is given the debt by the beneficiaries of the debt trust. In addition, the release may trigger IHT charges since an addition is being made to the property trust after 22 March 2006. See s52(3) IHTA 1984. The position is arguable.

Option 2: do nothing
A donor may sit tight and hope that litigation taken by HMRC against another taxpayer may be defeated. This course presents the settlor and trustees with considerable uncertainty. Certainty as to the IHT position may not be obtained for some years. In addition, there are continuing POAT charges for the settlor to pay unless they have made an election (in which case different issues would arise).

Option 3: repay the debt
The parties could renegotiate the loan and obtain early repayment (often at a discounted value if the loan is expressed not to be repayable until death). This may raise income tax or capital gains tax issues, but, if the property is being sold and the property trust now has spare cash, it is a possibility. Consider the impact of s103(5) FA 1986 on repayment of the loan. Arguably, even if s103 is relevant to home loan schemes in general, on repayment by the trustees during the lifetime of the settlor, there is no deemed PET under s103(5).

Litigation involving estates where the settlor has died

A case where the loan was not repayable on demand began to move forward in early 2012, with notices of determination and appeals. In the meantime, other estates were held up, which meant that, until the outcome of the litigation was known, it was not clear whether the property trust, the debt trust or the executors (or none) would be liable to pay any IHT, so a certificate of tax deposit could not easily be purchased to stop interest running.

To deal with this problem, HMRC, in its August 2012 newsletter, commented:

'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.'

Bear in mind that if HMRC eventually loses a home loan case and accepts that your case is similar or identical to any litigated case, your deposit will be refunded with interest at 0.5%, whereas interest on any unpaid tax is charged at 3%. It is suggested, therefore, that estates where the settlor has died should consider doing this on a without-prejudice basis (i.e. without accepting at this point that the tax is due) since in a sense they have little to lose if a test case proceeds.

The deductibility of the loan note (or not) is only in point in relation to the IHT on the deceased's estate; HMRC accepts that it remains deductible for the purposes of calculating any charges under the relevant property regime, such as tax on a ten-year anniversary.

Latest developments

In December 2012 the above test case settled in favour of the taxpayer, so HMRC is now looking for a new case to take. Although IHT was repaid on the test case, HMRC did not accept the technical merits of the scheme. HMRC agreed that the loan was deductible for IHT purposes, but only on the particular facts of that case, namely:

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

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

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

'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.'

HMRC now states 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.'

It is therefore important that executors of anyone who has done a home loan scheme should establish whether there has been any past POAT enquiry into the taxpayer's return. If there has been such an enquiry and a closure notice has been issued, with or without amendment, HMRC has indicated that it will accept that the scheme is effective for IHT purposes.

In addition, from my personal experience, HMRC does appear 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 will generally be given.

However, HMRC does not accept that the guidance that was repeatedly reissued before October 2010 binds it or raises any expectation that the taxpayer was entitled to assume that home loan schemes where the debt was not repayable on demand were accepted for IHT purposes. In my view, this is not correct. Where taxpayers can demonstrate that the deceased person relied 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, a legitimate expectation has been raised, and HMRC is not entitled to resile from that guidance. It is likely that this situation will apply in only a few cases. In many cases the taxpayers did not pay POAT or elected into reservation of benefit, or the loans were or could be repayable on demand. In these situations the pre-2010 guidance will be irrelevant.

In the meantime, the technical arguments on whether the home loan case works remain unresolved. HMRC will no doubt issue notices of determination against which another taxpayer can appeal, and another case will have to be taken.

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