New hurdles to overcome

In the second part of her series on home loan schemes, *Emma Chamberlain* reviews the current arguments relating to the schemes, including the impact of the recent *Shelford case*

KEY POINTS

- **What is the issue?**

HMRC now considers that in relation to a loan repayable on the donor's death, any home loan scheme fails to mitigate inheritance tax for four reasons.

- **What does it mean for me?**

The case of *Shelford* failed on the ground of 'no disposition', as the judge held that the sale agreement and loan agreement were both void. Although the double inheritance tax charge was avoided, the case raises new hurdles to overcome.

- **What can I take away?**

Where schemes are retained, the house trust should end on the death of the settlor and the house should pass outright to the children immediately on death in order to secure the residential nil rate band if possible.

In my first article in the March issue of *Tax Adviser*, I considered how home loan arrangements were set up and HMRC's historic attack on them. This article reviews current arguments and the recent *Shelford* case.

This article continues to consider the example of Andrew, a 70 year old with a property worth £1.5 million, who set up a home loan scheme to give away the value of his home but continue living there without a reservation of benefit problem and without losing main residence relief. See the March issue for full details of Andrew's situation.

Current HMRC arguments

HMRC now considers that in relation to a loan repayable on the donor's death, any home loan scheme fails to mitigate inheritance tax for four reasons:

1. Finance Act 1986 s 103 applies, with the result that the loan is not a valid deduction against the trust fund of the House Trust ('the s 103 argument').
2. The so-called '*Ramsay* principle' applies, so that the sale of the house is in reality a gift of the house and the continued occupation by the taxpayer involves a reservation of benefit ('the s 102 house argument').
3. The scheme involves a series of associated operations so that there is a reservation of benefit in the loan as the donor derives a benefit by associated operations ('the s 102 loan argument').
4. Where the sale was left resting in contract for stamp duty reasons, there is no disposition. As the settlor remains the owner, the value of the freehold still forms part of his estate for inheritance tax purposes (the 'no disposition argument').

Section 103 argument

Section 103 is designed to disallow the deduction of artificial liabilities. At its simplest, it catches situations where the donor makes a gift of cash to the donee, who at some later date lends the sum or other property back to the donor. The loan in these circumstances is not deductible.

HMRC puts the argument at IHT44106:

> 'The sale of the property to the first trust is a disposition and since, in the majority of cases, the trustees had no means with which

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to pay for the property, the steps they took to fund their purchase created the debt which (through the trustees equitable lien) is an incumbrance against the property. The consideration for the debt was property derived from the deceased and FA86/S103 applies to abate the loan.'

Section 103 is a complex section. It applies where:

- the deceased has incurred a debt, or an incumbrance is created by a disposition made by the deceased; and
- the debt or incumbrance consists of property derived from the deceased or consideration given by any person whose resources include property derived from the deceased.

There are a number of arguments against the application of s 103 here. First, it may not apply at all (see s 103(4)) where there is no transfer of value (given that Andrew's estate for inheritance tax purposes was not reduced in value by the sale as he had a qualifying IIP). Second, it is the trustees here (not Andrew, the donor) who incur the liability – a view confirmed in *St Barbe Green* [2005] STC 288. If that is right, HMRC must show that 'an incumbrance is created by a disposition made by the deceased'. If the lien of the trustees (the right to have recourse to the trust fund for repayment of the debt) is an incumbrance, is it actually created by a disposition of Andrew or does it arise as a matter of trust law?

Perhaps more fundamentally, 'property derived from the deceased' surely refers to 'any property which was the subject matter of a disposition made by the deceased'; i.e. property which had *already* been transferred by the deceased by a prior disposition *before* the loan back to the deceased. This necessarily envisages two dispositions, not one. However, in the case of a home loan scheme, the consideration for the debt or incumbrance is the deceased's currently owned property, not property which had previously been his. In short, it is a necessary condition of the application of s 103(1)(a) that there is a temporal gap between the prior disposition by the deceased which provides the consideration for the loan back and the subsequent loan back giving rise to the liability in the estate of the deceased. That condition is failed here.

Section 102 house argument

HMRC argues that the settlor (Andrew) makes a disposal of the house 'by way of gift', from which he is not excluded from benefit, in terms of s 102(1)(b), so that the house is 'property subject to a reservation' in terms of s 102(2). This is on the basis that the donor created the appearance of a sale, but without any intention that the donor would retain any value on disposal of the property. The disposal of the house to the trustees was not a fully commercial sale but it was not as such 'a disposal by way of gift' for inheritance tax purposes because there was no transfer of value. Andrew had a qualifying interest in possession in the entirety of the trust fund. If there was no transfer of value there was no gift.

'Gift' is used synonymously with 'transfer of value' not only in Finance Act 1986 Sch 19 para 1 s 101, but also in Sch 20 s 102. As Carnwath LJ said in *IRC v Eversden* [2003] STC 822: 'It would be surprising if the draftsman was intending to use the term "gift" in a radically different sense in two places in the same Act… Rightly or wrongly (from the purist's point of view), the draftsmen clearly did find it possible to equate a disposal by way of gift with a transfer of value.'

In short, a disposal to a settlement that does not result in a transfer of value (e.g. because the settlor has an initial qualifying life interest in the property disposed of) is not 'a disposal by way of gift' for the purposes of s 102(1). (Andrew was deemed to own it under Inheritance Tax Act 1984 s 49 on transfers made before 22 March 2006.) Therefore, the reservation of benefit rules do not apply at all.

If this is wrong, it is not clear why the debt liability falls to be disregarded in valuing the donor's estate at his death. In valuing settled property treated as being in a person's estate under either s 49 (IIP rules) or the reservation of benefit rules in Finance Act 1986 s 102(3), the trust liabilities should still fall to be deducted *per St Barbe* above. HMRC endorses this at IHTM 14401.

Section 102 loan argument

Clearly, the gift of the loan note *was* a disposal by way of gift to Andrew's children. Hence, the reservation of benefit rules can apply if the loan note is not enjoyed 'to the entire exclusion of the donor and of any benefit to him by contract or otherwise'.

The loan note is not actually enjoyed by Andrew as he has given it away but

HMRC relies on Finance Act 1986 Sch 20 para 6(1)(c) to say there is a benefit to the donor (Andrew) by associated operations. There has been no reported case specifically on this section.

The Court of Appeal in *Hood v HMRC* [2018] EWCA Civ 2405 and in *Buzzoni* [2013] EWCA Civ 1684 make it clear that in order for a reservation of benefit to arise within the second limb of s 102(1)(b) three conditions must apply:

1. The benefit must consist of some advantage which the donor did not enjoy before he made the gift.
2. The donor's benefit must be by virtue of the property he has given away.
3. In cases where the donor is said to benefit by contract or otherwise, there must be detriment to the donee.

In this case, the donor (Andrew) has nothing at the end of the process that he did not have at the start. He has the continuing right to live in the house. Unlike *Lady Hood*, he is not relieved from any covenants and does not receive anything new back. The rights under the loan note themselves do not confer a benefit on the donor. They are no different from the property rights carved out in a lease by Lady Ingram before she gifted the freehold. Even if it could have been argued that in not repaying the loan early, the donor had received a benefit by virtue of or referable to the gift, it is wrong to say that the donee suffers detriment by the debt not being repaid early. The contractual right which is the subject of the gift entitles the donees to repayment after the donor's death – they incur no detriment by not being paid earlier.

In short, it is far from clear that this argument would be successful, although the associated arguments analysis is complex.

No disposition argument

This is the ground on which the taxpayer failed in *Shelford*. The judge held that the sale agreement and loan agreement were both void under the Law of Property (Miscellaneous Provisions) Act 1989 s 2: 'The Sale Agreement does not incorporate all of the terms of the contract for the sale of the freehold of the house.' The documents did not reflect the true agreement reached between the parties and, if not outright shams, had an 'air of unreality' about them. The deed of assignment of the debt was therefore also void as it had nothing on which to bite. All inheritance tax savings were lost.

In *Shelford,* unlike many other home loan cases, the contract did not state that the purchase price was satisfied by the parties entering into a loan agreement scheduled out in the sale contract itself. Indeed, the sale contract did not suggest that the purchase price would remain outstanding at all. Even the loan agreement did not refer to an IOU as such but was drafted to lend £1.4 million to the trustees.

The judge held that counsel for the taxpayer was therefore wrong to argue that the loan agreement operated as a collateral agreement and effected payment of the purchase price by way of set off and discharge of the obligations under the sale agreement. No money was ever intended to be advanced and in that case Mr Herbert (the seller of the house) did not have the necessary funds of £1.4 million (being the purchase price) to lend to the trustees. The 'loan agreement' at best amounted to no more than the deferral of the obligation to pay the purchase price until Mr Herbert's death. Specific performance would not have been available to the trustees because the trustees neither had the purchase price nor were they in any position to obtain it, so they were not ready, willing and able to perform their side of the bargain. Therefore, no equitable interest passed from Mr Herbert in his lifetime and the whole of the value of the property remained in his estate.

The judge held that if the documents were not void, and the purchase price remained outstanding, such that the sale was for payment of consideration deferred to the date of death, then the settlor retained beneficial ownership in the house with the equitable interest only passing on completion of the legal title or on eventual payment of the purchase price after death. The effect until then was an uncompleted contract for sale which was caught by s 163 with the result that Mr Herbert's estate paid tax on the full value of the house at his death and the trustees paid tax on the increased value of the house (the difference between the value at death and the loan owed). This would lead to an element of double taxation. Although taxpayer's counsel argued vigorously against s 163 applying to uncompleted contracts for sale, these arguments were not successful.

In the end, as the judge held the whole scheme was void, there was no need for him to rule on the inheritance tax arguments which remain unresolved. The deceased taxpayer was treated as if he had continued to own the house throughout; his estate could recover the substantial amounts of pre-owned assets tax paid (net of 40% inheritance tax); and the children would simply inherit the house sale proceeds under the will net of inheritance tax. In short, the taxpayer's estate was no worse off than if the scheme had never been done.

Conclusions

Although the end result in *Shelford* may not have been disastrous in the sense that at least the double inheritance tax charge referred to above was avoided, it raises new hurdles to overcome. Certain property law issues must be dealt with before inheritance tax can even be resolved.

Other matters

How home loan dismantling will operate in the light of the 'no disposition argument' in *Shelford* remains to be seen. Will the taxpayer be able to argue that nothing has occurred and simply treat the home loan scheme as a nothing? This risks some problems later if a subsequent case decides that *Shelford* is wrong or that the facts are distinguishable. It is also problematic if the trustees later executed appointments to the children because (for example) the house had been sold and distributions were made.

In some cases, the donor taxpayer (Andrew) will still be alive and may want to wind up the scheme. This is likely to be sensible if the total estate is less than £1 million – for a couple with two nil rate bands and two residential nil rate bands, there is no inheritance tax to pay anyway, so why bother keeping the scheme in place with endless argument on the last death?

Practitioners should ensure that where schemes are retained, the house trust should end on the death of the settlor (Andrew) and the house pass outright to the children immediately on death (subject to the house trustees' lien) in order to secure the residential nil rate band if possible. If the house remains held in trust for the children, there will be no residence nil-rate band available. This may necessitate some amendment to the existing house trust now but effective on the donor's death.

There are a variety of ways of ending home loan schemes and a full discussion is outside the scope of this article. Practitioners will need to think carefully about any trust law issues (as the Children's Trust cannot benefit the donor) and capital gains tax or income tax issues on write off or appointment of the loan. Practitioners should note that if the taxpayer chooses to wind up the scheme, HMRC *will* now refund all past pre-owned assets tax without time limit. This refund is best secured by liaison with the Inheritance Tax Technical Division.