TAX CHAMBERS

15 OLD SQUARE

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

The New Treatment of Liabilities for Inheritance Tax Purposes:

Finance Bill 2013 Schedule 34

Introduction

1. IHT is generally charged on the net value of a deceased person's estate after taking into account all liabilities outstanding at the date of death, as well as other reliefs and exemptions which may be relevant.

2. In the Budget Statement on 20 March 2103 it was announced (without consultation) that Finance Bill 2013 would include a measure to:

   "*amend the IHT provisions which allow a deduction for liabilities owed by the deceased on death from the value of their estate. In some circumstances, the changes will bring in new conditions for the deduction to be allowable, or will restrict the deduction, so that the tax advantages resulting from the schemes or arrangements does not arise*".

3. The policy objective was stated to be:

   "*The measure will remove the tax advantage that these schemes and arrangements seek to achieve, and ensure that the value of an estate subject to IHT reflects the normal economic consequences of incurring a liability. The measure supports the Government's anti-avoidance strategy and fairness agenda*".

4. The background to the measure is:

   "*a response to avoidance schemes and arrangements which exploit the current rules that allow a deduction for liabilities owed by the deceased against the value of an estate regardless of whether or not the debt is paid after death. Some arrangements involve contrived debts which are subsequently not repaid so there is no real reduction in the value of the estate: others involve loans used to acquire assets which are not chargeable to IHT, or which qualify for a relief, so that the value of the estate is doubly reduced*".

5. For good measure, paragraph 12 of the Explanatory Notes to Schedule 34 adds that:-

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

"They will make arrangements which allow 'two bites at the cherry' unattractive because the estate will no longer gain the double benefit of a relief or exclusion and the deduction of a liability".

6. Schedule 34 of Finance Bill 2013 therefore includes three provisions in relation to liabilities for inheritance tax purposes:-

    a. Liabilities attributable to excluded property;

    b. Liabilities attributable to financing certain relievable property (business and agricultural property); and

    c. Discharging liabilities after death.

Commencement

7. Paragraph 5 of Schedule 34 FA 2013 provides:

    The amendments made by this Schedule have effect in relation to transfers of value made, or treated as made, on or after the day on which this Act is passed.

8. The new rules therefore apply to pre-2013 debts, if the transfer of value is after enactment. Fairness?

<u>Liabilities attributable to excluded property</u>

The disallowance

9. New section 162A IHTA provides:

    (1) To the extent that a liability is attributable to financing (directly or indirectly)-

    (a) the acquisition of any excluded property, or

    (b) the maintenance, or an enhancement, of the value of any such property,

    it may only be taken into account so far as permitted by subsection (2) or (3).

10. What is meant by "financing" an acquisition"? How will it be construed?

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

11. This will affect any borrowing by a foreign domiciled individual with both UK and excluded property. All liabilities will need to be reviewed.

12. Example 1:-

    A resident foreign domiciled individual wishes to purchase a UK home. His budget is £1m. If he borrows to purchase the home, the liability is deductible. If he sells foreign property to purchase the home, and subsequently borrows to purchase new foreign property, the liability is disallowed. Careful structuring of borrowing in relation the acquisition of property is, therefore, needed.

13. In addition, the new provisions are likely to have an impact on re-structuring arrangements undertaken (or to be undertaken) to avoid the new taxes on high value UK residential properties worth over £2 million and owned by non-natural persons.

14. In many cases such properties are being (or have been) taken out of corporate ownership to be held directly by individuals or trusts.

15. Example 2:-

    A non resident foreign domiciled individual whose UK property is held in an offshore trust/company wishes to "de-envelope" in response to the introduction of the Annual Tax on Enveloped Properties and the extension of the capital gains tax regime. Arrangements are entered into which include a sale of the property or the shares in the company, the purchase price payable being left outstanding on demand. Is the debt now disallowed under section 162A?

Disposal of excluded property

16. Section 162A IHTA provides:

    (2) Where the excluded property has been disposed of, in whole or in part, for full consideration in money or money's worth, the liability may be taken into account up to an amount equal to so much of that consideration as-

    (a) is not excluded property, and

    (b) has not been used-

    (i) to finance (directly or indirectly) the acquisition of excluded property or the maintenance, or an enhancement, of the value of such property, or

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

(ii) to discharge (directly or indirectly) any other liability that, by virtue of this section, would not be taken into account.

17. "Dispose" is not defined so will bear its normal meaning, not the extended CGT meaning.

18. Can this be used to assist if liabilities are caught?

Liability exceeds value of excluded property

19. Section 162A IHTA provides:

(3) The liability may be taken into account to the extent that it is greater than the value of such of the excluded property as has not been disposed of, but only so far as the liability is not greater than that value by virtue of-

(a) arrangements the main purpose, or one of the main purposes, of which is to secure a tax advantage,

(b) an increase in the amount of the liability (whether due to the accrual of interest or otherwise), or

(c) a disposal, in whole or in part, of the excluded property.

20. Section 162A(4) defines "tax advantage":

(4) In subsection (3)(a)-

"tax advantage" means -

(a) the avoidance or reduction of a charge to tax, or

(b) the avoidance of a possible determination in respect of tax.

21. "Tax" is not defined here, so it means IHT: see s.272 IHTA.

22. Example 3:

A UK resident foreign domiciliary borrows £2m to purchase excluded property. Over the course of a year, the excluded property reduces in value and is now worth £1m. The amount of £1m is deductible.

23. It should be noted that this relief is very limited. It would note cover any increase in the debt due to interest or index linking.

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

24. In the case of a foreign currency debt the debt is valued at the time it is taken out and an increase in the value of the debt due to currency fluctuations is not taken into account.

25. If the original excluded property is sold and other property purchased instead, prima facie, the relief does not apply.

Liabilities attributable to relievable property

26. Section 162B IHTA provides:

(1) Subsection (2) applies if-

(a) the whole or part of any value transferred by a transfer of value is to be treated as reduced, under section 104, by virtue of it being attributable to the value of relevant business property, and

(b) the transferor has a liability which is attributable, in whole or in part, to financing (directly or indirectly)-

(i) the acquisition of that property, or

(ii) the maintenance, or an enhancement, of its value.

(2) The liability is, so far as possible, to be taken to reduce the value attributable to the value of the relevant business property, before it is treated as reduced under section 104, but only to the extent that the liability-

(a) is attributable as mentioned in subsection (1)(b), and

(b) does not reduce the value of the relevant business property by virtue of section 110(b).

27. This disallows debts where the liability is attributable to "financing" the acquisition of property which qualifies for BPR.

28. Example 4: an individual borrows money in order to invest in property that qualifies for business property relief (the issued share capital in a software business) after he has owned the shares for two years. In so far as this was allowable before section 162B, it is now disallowed.

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

29. Section 162B IHTA also disallows liabilities that are attributable to financing the acquisition of agricultural property subject to APR:-

(3) Subsection (4) applies if-

(a) the whole or part of any value transferred by a transfer of value is to be treated as reduced, under section 116, by virtue of it being attributable to the agricultural value of agricultural property, and

(b) the transferor has a liability which is attributable, in whole or in part, to financing (directly or indirectly)-

(i) the acquisition of that property, or

(ii) the maintenance, or an enhancement, of its agricultural value.

(4) To the extent that the liability is attributable as mentioned in subsection (3)(b), it is, so far as possible, to be taken to reduce the value attributable to the agricultural value of the agricultural property, before it is treated as reduced under section 116.

30. Section 162B IHTA provides:-

(5) For the purposes of subsections (1) to (4) references to a transfer of value include references to an occasion on which tax is chargeable under Chapter 3 of Part 3 (apart from section 79) and-

(a) references to the value transferred by a transfer of value include references to the amount on which tax is then chargeable, and

(b) references to the transferor include references to the trustees of the settlement concerned.

31. Occasions on which tax is charged under the relevant property regime is included, as are transfers by trustees.

32. Section 162B IHTA makes provision for woodlands:-

(6) Subsection (7) applies if-

(a) part of the value of a person's estate immediately before death is attributable to the value of land on which trees or underwood are growing,

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

(b) the value of the trees or underwood is to be left out of account, under section 125(2)(a), in determining the value transferred by the chargeable transfer made on the person's death, and

(c) the person has a liability which is attributable, in whole or in part, to financing (directly or indirectly)-

(i) the acquisition of the land or trees or underwood,

(ii) planting the trees or underwood, or

(iii) the maintenance, or an enhancement, of the value of the trees or underwood.

(7) To the extent that the liability is attributable as mentioned in subsection (6)(c), it is, so far as possible, to be taken to reduce the value of the trees or underwood, before their value is left out of account.

33. Section 162B(8) deals with general definitions:

(8) In this section

"agricultural property" and "agricultural value" have the same meaning as in Chapter 2 of Part 5;

"relevant business property" has the same meaning as in Chapter 1 of Part 5.

34. Section 162C deals with liabilities within section 162A or B that have been partially discharged:

162C Sections 162A and 162B: supplementary provision

(1) This section applies for the purposes of determining the extent to which a liability is attributable as mentioned in section 162A(1) or 162B(1)(b), (3)(b) or (6)(c).

(2) Where a liability was discharged in part before the time in relation to which the question as to whether or how to take it into account arises-

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

(a) any part of the liability that, at the time of discharge, was not attributable as mentioned in subsection (1) is, so far as possible, to be taken to have been discharged first,

(b) any part of the liability that, at the time of discharge, was attributable as mentioned in section 162B(1)(b), (3)(b) or (6)(c) is, so far as possible, only to be taken to have been discharged after any part of the liability within paragraph (a) was discharged, and

(c) any part of the liability that, at the time of discharge, was attributable as mentioned in section 162A(1) is, so far as possible, only to be taken to have been discharged after any parts of the liability within paragraph (a) or (b) were discharged.

<u>Discharge of liabilities after death</u>

Disallowance of undischarged liabilities

35. Section 175A IHTA provides:

(1) In determining the value of a person's estate immediately before death, a liability may be taken into account to the extent that-

(a) it is discharged on or after death, out of the estate, in money or money's worth, and

(b) it is not otherwise prevented, under any provision of this Act, from being taken into account.

36. This looks like an allowance! The disallowance is in subsection (2).

37. Example 4: If a debt of £100 is discharged as to 50% by a payment of £50, then 50% of the debt is allowable. The provision does not deal with the position where a debt is wholly discharged at an undervalue. If, for example, the debt is wholly discharged by the transfer of money's worth valued £50, then it would be sensible if only 50% of the debt is allowable.

38. There are no provisions to deal with the position where a liability is discharged after the time that an IHT account is delivered or after IHT is paid.

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

39. It should be noted that this disallowance only applies on death, it does not apply to lifetime transfers (failed PETs or chargeable transfers) or to 10 year and exit charges on trusts.

40. Where loans have interest accruing, it will now be necessary for the loan to be repaid (with tax on the interest being due) for the deduction to be available. Before these provisions it was possible to obtain a deduction and then waive the loan (with no interest being due).

Commercial reason for non-payment of liabilities

41. Section 175A IHTA provides:

(2) Where the whole or any part of a liability is not discharged in accordance with paragraph (a) of subsection (1), the liability or (as the case may be) the part may only be taken into account for the purpose mentioned in that subsection to the extent that-

(a) there is a real commercial reason for the liability or the part not being discharged,

(b) the liability or the part is not being left undischarged as part of arrangements the main purpose, or one of the main purposes, of which is to secure a tax advantage, and

(c) the liability or the part is not otherwise prevented, under any provision of this Act, from being taken into account.

42. A common case will be where the debt is not due and payable at the time of the death. It cannot be expected to be discharged before it falls due.

(3) For the purposes of subsection (2)(a) there is a real commercial reason for a liability, or part of a liability, not being discharged where it is shown that

(a) the liability is to a person dealing at arm's length, or

(b) if the liability were to a person dealing at arm's length, that person would not require the liability to be discharged.

43. Section 175A(4) IHTA defines "tax advantage". The definition is different from that in s.162A:

(4) In subsection (2)(b)-

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

"tax advantage" means-

(a) a relief from tax or increased relief from tax,

(b) a repayment of tax or increased repayment of tax,

(c) the avoidance, reduction or delay of a charge to tax or an assessment to tax, or

(d) the avoidance of a possible assessment to tax or determination in respect of tax.

(5) In subsection (4) "tax" includes income tax and capital gains tax.

44. If these requirements are met then it does not matter if the debt is later waived.

45. The most common cases where this rule is likely to be relevant is nil rate band discretionary trust debts and home loan schemes.

46. Example 5:

An individual sells an asset to his spouse in return for an IOU. It was intended that when she died the IOU is deducted from her estate, even though her husband may never have intended to recover the debt.

As a result of section 175A, where debts are not repaid on the wife's death, the executors will have to demonstrate a commercial reason for retaining the debt, not simply a desire to secure a tax advantage. If they cannot, the debt will not be deductible.

Liability discharged in part

47. Section 175A IHTA provides:

(6) Where the liability is discharged as mentioned in subsection (1)(a) only in part-

(a) any part of the liability that is attributable as mentioned in section 162A(1) is, so far possible, taken to be discharged first,

(b) any part of the liability that is attributable as mentioned in section 162B(1)(b), (3)(b) or (6)(c) is, so far as possible, taken to be discharged only after any part of the liability within paragraph (a) is discharged, and

(c) the liability so far as it is not attributable as mentioned in paragraph (a) or

Amanda Hardy
Tax Chambers,
15 Old Square, Lincoln's Inn,
London, WC2A 3UE
Tel: (020) 7242 2744
taxchambers@15oldsquare.co.uk

(b) is, so far as possible, taken to be discharged only after any parts of the liability within either of those paragraphs are discharged.

Conclusion

48. As drafted, the new measures potentially have major consequences for many family businesses, for foreign domiciliaries and for investment in the UK (all of which the Government are keen to support).

49. In many cases (including those without any element of tax avoidance) existing liabilities will have been incurred in reliance of the current rules.

50. Existing IHT planning will need to be revisited to ensure that it is still effective.

51. Amendments are, of course, still possible, if representations are made.

Amanda Hardy

Lincoln's Inn

24 April 2013