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# SCHEDULE A1 INHERITANCE TAX ON OVERSEAS PROPERTY REPRESENTING UK RESIDENTIAL PROPERTY

Assume in all cases that the companies are close and that the relevant trust is an excluded property settlement and that the relevant individual is foreign domiciled

**Version 3, which has been updated for further discussions with HMRC in connection with questions 7 and question 11, example 5. Published 27 February 2020**

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## **FOREWORD**

### **Introduction**

These professional body Questions and Answers are intended to assist professional advisers. Questions and draft suggested answers have been prepared by committee members of ICAEW, STEP, CIOT and LSEW to highlight and consider areas of uncertainty in the statutory provisions for:

- rebasing and the changes to the CGT foreign capital losses election
- cleansing of mixed funds
- trust protections and other trust issues
- the extension of IHT to overseas property representing UK residential property interests (these Questions and Answers)

as introduced by Finance Act (No 2) Act 2017 with effect from 6 April 2017.

### **HMRC response**

HMRC comments are below each suggested answer in bold.

### **Caveat**

These Q&As are intended to assist professional advisers in considering generic issues with respect to IHT on overseas property representing UK residential property interests.

The Q&As do not constitute advice and are not a substitute for professional consideration of the issues by the professional adviser in each client's specific context. Furthermore, these Q&As should be read in conjunction with HMRC's comments and advisers should consider the position to take for themselves. Where an adviser adopts a position contrary to that of HMRC the fundamental principles and standards set out in PCRT (with particular reference to paragraph 2.21 et seq.) should be considered in terms of communication with the client and any reporting and disclosure required.

## **QUESTION 1 – TEN YEAR ANNIVERSARY CHARGE OR OTHER CHARGEABLE EVENT OCCURRING BETWEEN CONTRACT AND COMPLETION**

The legislation contains no express provisions to cover the IHT position where a chargeable event arises on a company's acquisition or disposal of the UK residential property interest between contract and completion. If a ten-year anniversary charge, death or other chargeable event occurs between contract and completion, is schedule A1 in point? A consistent approach needs to be taken as otherwise there could be a double charge on the vendor and the purchaser if each of them suffered a chargeable event on residential property between contract and completion. For example, the purchasing trust had entered into a contract for the purchase of UK residential land just before a ten year anniversary and the vendor died before completion.

Until the sale has been completed in the sense that the purchase price has been paid and possession of the property has been taken, as a matter of law full beneficial ownership of the residential property itself has not passed. The property in question held by the purchaser is not the residential property as such but the benefit of the contract which contract is subject to specific performance if consideration has been given for the contract. See Lewin on Trusts para 10-006 in the 19th edition.

Para 8 Schedule A1 defines a UK residential property interest as an interest in UK land (a) where the land consists of a dwelling or (b) to the extent that the land includes a dwelling or (c) the interest subsists under a contract for an off plan purchase.

Interest in UK land has the meaning given by para 2 of sch B1 TCGA 1992 namely “*an estate, interest, right or power in or over land in the UK or the benefit of an obligation, restriction or condition affecting the value of any such estate, interest, right or power*” but this does not as such bring in any timing provision comparable to s28 TCGA 1992 which is a deeming provision that operates for CGT purposes only. As noted above, the property before completion is not the residential property but the benefit of the contract. The two assets may be the same value (if the house does not increase in value) but they are different property. See *Jerome v Kelly* [2003] STC 206 and the Court of Appeal decision in *Underwood v R.C.C* [2009] S.T.C. 239.

The IHT legislation refers to a contract for an off-plan purchase but does not deal with contracts more generally. However, it is assumed that a contract would be regarded as an estate in land for this purpose.

### **Suggested answer**

The value of the interest in the close company or partnership in a contract over land before completion is attributable to UK residential property in the hands of the purchaser and the land remains UK residential property in the hands of the vendor. When valuing the contract, however, in the hands of the purchaser it will have minimal value equal to the deposit. Only in very exceptional circumstances will any significant value have accrued. Eg. if the house goes up in value considerably before completion.

**HMRC: We agree that the value of the purchaser’s right would be subject to the obligation to pay the consideration.**

## **QUESTION 2 – CONTRACT AND COMPLETION AND LOANS**

If HMRC agree, do they take the same view in relation to loans, i.e. is a loan a relevant loan for para 4 purposes only when the residential property interest has been acquired on completion? Equally, the loan only ceases to be a relevant loan when the disposal of the residential property is completed.

### **Suggested answer**

In practice the bulk of the loan will only be drawn down when the full purchase price is paid. At that point whether the purchase price has been paid on exchange or completion, the loan is a relevant loan.

**HMRC: In practice, yes. There must be a loan and that would occur when it is drawn down and that loan becomes a relevant loan when the interest in UK land is acquired.**

## **QUESTION 3 – PARA 2(3): DE MINIMIS PROVISIONS.**

The wording in para 2(3) is not entirely clear or as might have been expected. Note that there is no *de minimis* exemption just because the company only owns a very small amount of residential property.

Paragraph 2(3) of Schedule A1 provides that where the value of the interest in the close company or partnership is less than 5 per cent of the total value of all the interests in the close company or partnership it is ignored for the purposes of Schedule A1. Curiously this *de minimis* provision does not value the minority shareholding and then compare it with the value of the company as a whole or look at how much value in the company is derived from residential property. Instead it compares the value of each participator’s interest with the value of total participators’ interests in the company.

Does HMRC agree that this will lead to different results depending on whether the shareholder interests in a company comprise one majority shareholding or many small shareholdings and the extent to which the company is funded by borrowings?

### Example 1

Newco is owned by two unconnected people, one of whom holds 80 per cent and the other 20 per cent. That 20 per cent interest might well be worth less than 5 per cent of the aggregate value of the 20% interest and the 80% interest.

If on the other hand five unconnected people own 20 per cent each then it is unlikely the *de minimis* exemption will apply.

If Newco is funded with a loan from an unconnected third party of, say, 70% of the value of the property, the *de minimis* exemption is likely to apply to a 20% shareholding in both of the above patterns of shareholdings.

Do HMRC agree?

### Suggested answer

We broadly agree with the above analysis. The alternative option that the draftsman could have adopted is to compare the value of the relevant person's interest with the value of 100% of the share capital but that is not the approach here. It should also be borne in mind that if a shareholder owns a company X Ltd which in turn owns a small interest of Y Ltd which holds the residential property, the *de minimis* provisions must be applied through all levels upwards. The value of the interest of X Ltd may be less than 5% of the total value of all the interests in Y Ltd.

**HMRC: We agree with your interpretation of the *de minimis* provision.**

## QUESTION 4 – CONNECTED PARTY INTERESTS AND DE MINIMIS PROVISIONS

The *de minimis* provision does aggregate connected party interests but it is not entirely clear how this works. Para 2(4) says that one is to treat the value of the person's interest as increased by the value of any connected person's interest in the close company or partnership. This seems to differ from valuing the aggregate of the interests of the relevant person and all those connected with him.

### Example 2

Adam and his son and daughter each has a 3% shareholding in a close company where each 3% is only worth 1.5% of the total value of all the interests in the company. As worded do HMRC agree that the value of Adam's interest is increased by the value of his children's interests – to 4.5% of the total value of all the interests in the company? If instead one valued the aggregate of the interests of Adam and his children, Adam's enlarged interest might then be worth 5% or more of the total value of all the interests in the company.

### Suggested answer

The first approach should be taken so that Adam's interest is increased to 4.5% of the total value of all interests in the company.

**HMRC: We agree that the aggregation is of the value, i.e. 3\*(value of 3% shareholding) rather than the value of a 9% shareholding.**

## QUESTION 5 – DEATH AND CONNECTED PARTIES

Do HMRC agree that as with CGT, trusts set up by the settlor cease to be connected to any person connected with the settlor on the settlor's death?

## Suggested answer

We agree

**HMRC: We agree that there is nothing in SchA1 that alters the connected party rules.**

## QUESTION 6 – CORPORATE LIABILITIES

The legislation lays down a specific rule in paragraph 2(5) of Schedule A1.

*“in determining whether or to what extent the value of an interest in a close company or in a partnership is attributable to a UK residential property interest ...liabilities of a close company or partnership are to be attributed rateably to all of its property...”<sup>1</sup>*

The position is reasonably clear for companies as loans to companies cannot be relevant loans and the purpose for which the loan is taken out is irrelevant. However, a loan to a partnership can be a relevant loan within para 4 if used to finance the acquisition of UK residential property.

### Example 3

A partnership holds a UK residential property worth £2 million and borrows £10 million from X (a foreign dom) to invest in equities. This is not a relevant loan. However, the loan reduces the value of the UK residential property pro rata. The same is true if a company borrows to buy equities. The loan is still in part deductible against the value of the residential property.

If the partnership borrows £2m to purchase residential property but also owns other assets of £10m, only one sixth of the borrowing reduces the value of the residential property for the purposes of calculating tax on the partnership interest but the entire loan is a relevant loan and therefore a non-excluded asset and fully chargeable to IHT. Do HMRC agree?

By contrast if the loan is to a company that is a para 2 participator interest not a relevant loan and only a proportion of it will be charged as only a proportion will be attributable to residential property.

We note that a loan to an individual trust or partnership to acquire or improve UK residential property is a relevant loan, whether the creditor is a company, individual, trust or partnership. IHTM04313 wrongly omits loans made by a close company.

## Suggested Answer

We agree.

**HMRC: We agree and we have replaced the word “by” with “to” in the first line of IHTM 0413.**

## QUESTION 7 – PARAGRAPH 3 – COLLATERAL AND RELEVANT LOANS

1. There are a number of different approaches to determining whether assets are “held or otherwise made available as security, collateral or guarantee” for a relevant loan within the meaning of paragraph 3(b) of schedule A1.
2. The policy was to secure that property given as security for a loan is, in appropriate circumstances, brought within the scope of inheritance tax.
3. Bearing this in mind, it would normally be expected that property given as security will fall within paragraph 3(b) of schedule A1, unless (what would otherwise be) the security, collateral or (property standing behind a) guarantee is too remote from the relevant loan.

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<sup>1</sup> IHTA 1984 Sch. A1 para.2(5).

4. What would otherwise be the security may well be too remote where the lender has some sort of generic security over assets held by a lender on behalf of the borrower. This would include, for example, a right of set-off or a general pledge contained in a bank's standard terms and conditions or a right of set-off which arises under common law or the law of the jurisdiction in which the lender is based. A right of set-off or general pledge does not "incumber" the assets over which it subsists provided that the customer is free (in the absence of a default) to withdraw those assets at any time. In that sense the lender can only "be secure" (in the sense of having confidence) that those assets are available to it once a default has happened. Until such a default the position is inchoate: the security can be thought of as not yet formed.
5. Such an interpretation also provides symmetry with the phrase "incumbrance on any property" in s162(4) IHTA .
6. There may be other situations where it can be shown that assets which are held as security by the lender have no connection with the relevant loan (for example they may be security for a different liability) but this would need to be considered on a case by case basis taking into account all of the relevant facts.
7. As far as guarantees are concerned, it must be borne in mind that the way in which schedule A1 operates is to "de-exclude" property which is in some way supporting the relevant loan. A guarantee is not itself property of the guarantor. This means that where a guarantee is completely unsecured (in the sense above) and so is not connected with any particular property of the guarantor, the guarantor's assets remains excluded property. On the other hand, if the guarantor has provided some form of security or collateral for their obligations under the guarantee, the assets in question will fall within paragraph 3(b) of schedule A1.

Do HMRC agree?

**HMRC: HMRC agrees that the legislation was not intended to interfere with normal banking arrangements. Therefore, HMRC agrees with the analysis set out above subject to the following comments.**

**One point to bear in mind however is that there is a cap on the security which can be taken into account for the purpose of paragraph 3(b) so HMRC would expect that the distinctions above would only be of relevance if the value of the non – UK property held as security – that was specifically given in relation to the loan and that was therefore clearly within the definition – was less than the value of the loan.**

**Para 4: In some instances, the examples given may fall within paragraph 3(b) depending on the facts of a particular case.**

**Para 7: Again, as to what extent the funds of the guarantor are made available, would be viewed by HMRC as a question of degree and fact. If the creditor's only recourse to the guarantor for the failure of the primary debtor to repay is the guarantee and there is not an additional connection to any particular property of the guarantor then we would be inclined to agree.**

## **QUESTION 8 – SCOPE OF RELEVANT LOANS (1)**

Where funds are borrowed to pay the SDLT or other related legal and other expenses (not being expenses relating to the enhancement or maintenance of the value of the UK residential property interest) on the acquisition of UK residential property interest, would this be a "relevant loan"?

### **Suggested answer**

Even though paragraph 4(1) of Schedule A1 IHTA defines a "relevant loan" as a loan where money or money's worth is made available under the loan and is used to finance directly or indirectly the acquisition, enhancement or maintenance by an individual, a partnership or the trustees of a settlement of UK residential property or the acquisition by such individual, partnership or trust of a

close company which owns or acquires such property, this wording is not intended to include borrowed funds which are used to pay SDLT, and other incidental costs of acquisition within the meaning of s38(2) TCGA 1992, provided such expenses do not relate to the enhancement or maintenance of the value of the UK residential property interest"

**HMRC: We agree with your suggested answer.**

## **QUESTION 9 – SCOPE OF RELEVANT LOANS (2)**

Where funds are borrowed to service the interest on a "relevant loan" is this additional borrowing also a "relevant loan"?

### **Suggested answer**

Servicing the interest on a relevant loan does not result in the acquisition of a UK residential property interest and neither does the expense relate to the enhancement or maintenance of the value of the UK residential property interest. As such, there is no "relevant loan".

**HMRC: We do not agree. If the interest is part and parcel of financing the purchase price of the UK residential property then then the making of an additional loan to service that interest will be a relevant loan, whether directly or indirectly.**

## **QUESTION 10 – SCOPE OF RELEVANT LOANS (3)**

Where funds are borrowed, so an individual can pay his or her rent in relation to a UK residential property does this create a "relevant loan"?

### **Suggested answer**

Such a loan would be a relevant loan as a tenancy agreement is sufficient to create an interest in residential property. The HMRC CGT Manual at CG64471 states:

*"The only circumstance in which an individual can reside in a property in which he has no legal or equitable interest is under licence. A licence is a permission to reside in a property which may be contractual or gratuitous. Examples of residence under contractual licence are staying in a hotel or lodgings. An example of residence under gratuitous licence is staying with family or friends."*

The exception to this would be where the specific legislation (paragraph 8) defining "UK residential property interest" excludes the interest from the definition.

For example, purpose built student accommodation meeting the conditions set down at paragraph 4(8), Schedule B1, TCGA 1992 does not come within the definition of "UK residential property interest" and so a loan to allow an individual to pay their rent on qualifying purpose built student accommodation would not be a "relevant loan".

**HMRC: We would agree. The obligation to pay the rent is, like the interest in the example above, financing the acquisition cost of the tenancy.**

## **QUESTION 11 – COLLATERAL AND DOUBLE CHARGES**

The provisions could operate unfairly in certain circumstances. The draftsman tended to assume that loans taken out for the purchase of UK property would be deductible only against that property or the element of collateral that is chargeable to IHT and therefore the borrower would be in a neutral position. The difficulty is that in many cases the property AND the collateral offered for a loan are likely to be chargeable in full and moreover the loan is not necessarily deductible against any of the chargeable property, thus leading to charges in excess of the value of the property. A



few simple examples will illustrate the point.

#### Example 4

Father and daughter are both domiciled in France. Daughter lives in the UK and father lends her £1m to buy a London flat. He takes as security her Paris property or maybe makes the loan unsecured. The effect is as follows:

- a) Father has made a “relevant loan” which is not excluded property. It will therefore be subject to IHT on his death. Indeed as daughter is UK resident the loan is likely to be a UK situated asset anyway unless made a specialty debt or secured on non-UK property;
- b) Daughter owns a UK situs asset (worth £1m) and the debt that she owes her father is owed to a non resident and will be discharged in France “so far as possible” thus reducing the value of daughter’s property outside the UK (see IHTA 1984 s162(5)).
- c) The result is that both the loan (which will be set against daughter’s non-UK assets) and the full value of the London property are brought within the IHT net. If father releases the loan he will make a PET.

#### Suggested answer

We agree with the above analysis although double tax treaty relief in both cases should be considered. Otherwise the loan should expressly be charged on the UK property so that it comes within the terms of s162(4).

**HMRC: We agree with your analysis of SchA1 and we also agree that the liability will have to be deducted from foreign assets to the extent that IHTA/s162(5) applies. However, the eventual outcome may be mitigated by the effect of a double taxation convention or IHTA/s159.**

#### Example 5

Mr L, who is resident and domiciled in Malaysia, purchases a buy to let flat in Battersea for £1 million through a wholly owned BVI company. The BVI company owns no other assets. He borrows £600,000 of the purchase price from his bank in Malaysia which he then lends to the company together with £400,000 from his own money. The bank loan is formally secured on a portfolio of investments belonging to Mr L and held by the Malaysian bank worth £1.8 million. On Mr L's death, the UK property is worth £1.5 million.

Mr L's interests in the BVI company include the loans of £1 million and the equity in the company which is now worth £500,000. These interests will be subject to inheritance tax on his death. (£1.5m). This is comprised of his interest as a participator by reason of being a loan creditor, and the equity in the property.

In addition, the loan from the bank is a relevant loan as it is a loan to an individual which has been used to acquire an interest (in this case the onward loan to the company) in a close company which in turn uses the money to acquire a UK residential property interest. Inheritance tax will therefore potentially also be payable on the value of the collateral up to the amount of the loan (£600,000). The total potential value subject to inheritance tax on Mr L's death is therefore £2.1 million (£1.5 million plus £600,000).

The loan from the bank of £600,000 is in principle deductible from the collateral. However, is it deductible in its entirety only from the value of the collateral which is within the scope of inheritance tax or might the deduction be taken pro rata against the whole of the £1.8 million of collateral? If the latter, only £200,000 ( $£600,000 \times £600,000 / 1,800,000$ ) of the loan would be deducted from the £600,000 of collateral which is taxable. S162(5) IHTA offers no express answer to this point.

The position would be different if the bank lent direct to the BVI company and Mr L offered personal investments as collateral for this loan. In that case as the collateral is not to secure a relevant loan the personal investments are not chargeable. See example 9 later for further details.

## Suggested answer

In practice we will accept that the loan is deductible only from the collateral that is within the scope to IHT. Therefore, all the £600,000 is deducted from £600,000 of the £1.8m collateral which is chargeable. The total amount subject to inheritance tax on Mr L's death will be £1.5m and for this purpose the collateral is effectively ignored. This is because the collateral is only chargeable up to the value of the amount lent and therefore the loan should be deductible against that part of the collateral. The policy intention is not to impose a double charge but simply ensure that the full value of the house is chargeable to IHT when the loan has been secured by means of other collateral.

**HMRC: We agree that the value of the property in Mr L's estate would be £2.1M and the question is how to take account of an allowable liability (of £600,000) which is an incumbrance on property (£1,800,000) that is partly chargeable (£600,000) and partly excluded (£1,200,000). Like you, we take the view that for the purposes of SchA1 the liability should be set off against the value in the UK estate so that the value chargeable to IHT is £1,500,000. This view is confined to SchA1 and should not be taken as applying to other similar situations that may be covered elsewhere in the IHTA 1984.**

## QUESTION 12 – COLLATERAL OR SECURITY EXCEEDING AMOUNT OF BORROWING: S162

### Example 6

Mrs M, a French resident, borrows £1m from a French bank to buy a house in the UK worth £1.5m. Her personal investment is £0.5m. She offers a portfolio of non-UK shares worth £800,000 and a property in France worth £1.2m. i.e. total non-UK security charged is £2m for a property worth £1.5m and a loan of £1m.

Could HMRC confirm the following:

1. That the reference to the "extent to which it does not exceed the relevant loan" in para 3 refers to the totality of the collateral. i.e. that only £1.0m of the combined collateral will fail to be excluded property rather than the whole of the value of the shares (being less than the £1 million loan) and £1 million of the value of the French house (i.e. £1.8 million in total) being within the charge to IHT?

### Suggested answer

This is confirmed

### HMRC: This is confirmed.

2. What would the position be if the bank could only enforce against the foreign assets once the UK house was found to be insufficient to meet the borrowing and there was a formal charge against the UK house? In that event under s162(4) the borrowing reduces the value of the house for IHT purposes. Does this mean £500K of the equity in the house is chargeable and £1m of the overseas collateral? i.e total of £1.5m.

### Suggested Answer

We agree a total of £1.5m is charged to IHT on death even though the loan is deductible under s162 against the value of the house (the net £500K value of the UK house and £1 million of the non-UK collateral).

3. The position will be particularly important to resolve as Mrs M might leave the UK property and the shares and French property subject to IHT but to different people under her Will. Matters get more complicated where perhaps some collateral is provided by the borrower and other collateral is provided by another person such as the parent of the borrower.

**HMRC: We agree that a total of £1.5M is within the charge to IHT.**

### **QUESTION 13 – WHAT IS THE POSITION WHERE LOANS ARE REFINANCED AND THEN THE PROPERTY IS SOLD?**

#### **Example 7**

A lends to B who purchases a UK property. A has a relevant loan but then B repays A and borrows from a bank. The repayment of the loan received by A is within the IHT net for two years under para 5.

Shortly after refinancing and within the two years B sells the property. HMRC seem to assume at IHTM 04314 Example 3 that the repayment proceeds received by A will then be excluded property. However, para 5 does not treat the repayment proceeds as a relevant loan and so para 4(4) is inapplicable. The two years continues to run even though if B had sold the property and only then repaid A no two year rule would operate.

We assume also it is right that if B had sold the property and not repaid A but left the loan outstanding it would cease to be a relevant loan and the two year rule in para 5 does not apply.

#### **Suggested answer**

We agree with the above analysis.

### **QUESTION 14 – ROB AND S103 – BORROWING ISSUES**

#### **Example 8**

Ms M is resident but not domiciled (or deemed domiciled) in the UK. She has established a non-UK settlement which holds its assets through a non-UK company owned by the trustees. Ms M is a beneficiary of the trust. In order to purchase a property in the UK for £1 million, Ms M borrows £1 million from the company paying an arm's length rate of interest.

On Ms M's death, the property is worth £1.3 million.

The debt may be deductible from the value of the property assuming the loan is repaid leaving a net value subject to inheritance tax of £300,000. It is however possible as a result of sections 162(5)/175A IHTA or (in some circumstances), section 103 Finance Act 1986 that the debt will not be deductible in which case the full £1.3 million value of the property will be within the scope of UK inheritance tax.

In addition, as the property held by the trust is subject to a reservation of benefit (as Ms M is a beneficiary), the value of the shares in the company owned by the trust will, to the extent that their value is attributable to the loan to Ms M (£1 million) be subject to inheritance tax on Ms M's death as non-excluded property. The total amount on which inheritance tax is payable will therefore either be £1.3 million or £2.3 million. This takes no account of ten yearly charges to which the trustees will be subject by virtue of holding a company within para 2.

#### **Suggested answer**

We agree that, depending on the circumstances, the total amount subject to inheritance tax on Ms M's death could be £2.3 million.

**HMRC: We agree that, depending on the circumstances, the total amount subject to inheritance tax on Ms M's death could be £2.3 million.**

## QUESTION 15 – ROB - FURTHER QUERIES

Instead of Ms M borrowing from the company, she borrows from a UK bank which takes security over the house but also is given a guarantee by the company secured over its assets.

In these circumstances, the debt to the bank is deductible (subject to section 175A IHTA). However, the value of the shares in the company owned by the trust will be within the scope of inheritance tax but capped at the amount of the loan. The likelihood therefore is that the total amount subject to inheritance tax on Ms M's death will be the £300,000 net value of the house and the value of the shares in the company owned by the trust up to £1 million - i.e. £1.3 million in total.

### Suggested answer

We agree that the tax charge in this situation will be on £1.3 million as long as a deduction for the debt is not denied by section 175A.

**HMRC: We agree that the tax charge in this situation will be on £1.3 million as long as a deduction for the debt is not denied by section 175A.**

## QUESTION 16 – COLLATERAL AND LOANS TO COMPANIES

Do HMRC agree that collateral provided for a loan **to** a close company is not caught as it is only collateral made to support relevant loans that is within the scope of the charge. So, for example, if a company borrows from a bank to purchase residential property and that is backed by collateral from the shareholder, such collateral is not subject to IHT. The bank loan is not a relevant loan as it is not taken out to purchase UK residential property by an individual, trust or partnership and the bank is a loan participator but outside the scope of inheritance tax (if not close).

### Suggested answer

We agree

**HMRC: We agree.**

### Example 9

The facts are the same as in Example 5 above except that the bank has made the loan direct to the BVI company (but still secured on Mr L's portfolio).

The loan to the BVI company is not a relevant loan as it is not made to an individual, a partnership or the trustees of the settlement. Mr L's collateral is not therefore subject to inheritance tax on his death. In addition, the loan is deductible from the value of the property in calculating the value of Mr L's interest in the BVI company. The value of his interest in the BVI company is therefore £900,000 (£1.5 million minus £600,000). The total amount on which inheritance tax is payable on Mr L's death is £900,000.

### Suggested answer

We agree that, in this situation, the only liability to inheritance tax on Mr L's death is on the net value of Mr L's interest in the BVI company which will be £900,000. This assumes the BVI company holds no other assets.

**HMRC: We agree that, in this situation, the only liability to inheritance tax on Mr L's death is on the net value of Mr L's interest in the BVI company which will be £900,000. This assumes the BVI company holds no other assets.**

## QUESTION 17 – COLLATERAL AND THE TWO YEAR RULE

Please confirm that the two year rule does not apply to collateral, whether or not such collateral is provided in respect of relevant loans or loans to companies

### Example 10

Father provides collateral for bank borrowings taken out by his son to purchase residential property; if that collateral is released the father is immediately outside the scope of IHT.

### Suggested answer

Confirmed. We agree with the analysis in the above example.

**HMRC: We agree that releases of collateral are not within the two-year disposal rule in paragraph 5.**

## QUESTION 18 – MEANING OF “INDIRECTLY FINANCES” IN THE DEFINITION OF “RELEVANT LOAN”

Under paragraph 4(1) Schedule 10, a loan is a relevant loan if the money lent is used to finance directly or indirectly a UK residential property interest (or various other categories of property). The use of the “directly or indirectly” language is common in tax statutes and paragraph 4(2) gives some non-exhaustive examples of indirect financing.

Clearly, however, there must be some limits to the meaning of “indirect”. If A lends to B who buys a car, which he sells 4 years later; and then gives the proceeds of sale to his children; and those children 3 years after that unexpectedly buy a UK residential property, then it would be difficult to argue that A has indirectly financed the acquisition of a UK residential property interest. However, it is unclear whether what breaks the chain is (a) the purpose of the loan (b) the intention of the borrower (c) the proximate use of the proceeds (d) the unexpectedness of the residential property purchase (e) the passage of time (f) a new actor in the chain (g) some other factor or (h) some combination of the above.

### Suggested answer

The use of the verb “to finance” is important here. In relation to similar language in s162A IHTA 1984, HMRC has confirmed (for instance) that a person borrowing to buy a UK house (and thereby not using non-UK monies which they would otherwise have used to effect that purchase) cannot be said to be “financing” the maintenance of the non-UK monies; rather they are “financing” the purchase of the UK house.

It is not possible to give hard and fast guidance covering every case. However, in interpreting whether a loan “indirectly finances”, one needs to examine – using a realistic assessment of the facts and a credible view of the parties’ intentions – what the purpose of the loan was and what it was contemplated would be done with the proceeds. Para 4(2) makes it plain that one cannot get out of the relevant loan provisions simply by inserting an intervening asset or an intervening person in the chain. But if the loan is intended for one purpose which is fulfilled then an unexpected subsequent use of the monies, such as in the example above, would not constitute the indirect financing of a UK residential property interest,

**HMRC: We agree that there could be cases where a factual link between a loan and an acquisition is too remote for it to be a relevant loan.**

## **QUESTION 19 – LENDER UNSURE WHAT A BORROWER HAS DONE WITH THE PROCEEDS OF A LOAN**

Lenders may not always know what a borrower has done with the proceeds of a loan. How, in such a case, are lenders to assess whether some or all of their loan is a relevant loan?

### **Example 11**

Mr J is a wealthy individual with many different investments and interests worth hundreds of millions. Many of these investments are illiquid and, from time to time Mr J has cash-flow difficulties. At such times he borrows from a family trust set up, many years ago, by his (non-domiciled and non-resident) mother. Mr J is clearly good for the money and the trustees do not impose any particular restrictions on the use to which he puts the borrowed-monies: they are simply for his general lifestyle needs.

Mr J spends the money on a variety of things including school fees, holidays, living expenses and (potentially) in maintaining one or more of his homes around the world (including the UK). Mr J also uses the monies to make payments to his ex-wife under their divorce settlement. His ex-wife spends those payments on a similar range of things which may include enhancing or maintaining her UK property.

The family trust, which until now has been an excluded property trust, has a 10 year anniversary approaching and needs to know what proportion of the loans to Mr J may be “relevant loans”. However, the loans all predate the 2017 provisions (in some cases by up to 20 years), and it is impossible for either the trustees or Mr J to reconstruct what Mr J did with the loans. The position is even more difficult in relation to a closely controlled foreign bank which may have made many 100s of loans without inquiring in all cases how such borrowings are used. On the death of a shareholder or partner how can the executors proceed?

### **Suggested answer**

As in the previous question the use of the verb “to finance” is important here. The trustees and Mr J should make as detailed enquiries as they can and if it is clear that a particular residential property interest – for instance a new purchase or a major refurbishment or extension of an existing property – was clearly what the loan was spent on, then they should report accordingly. However, where it is clear that the purpose of the loan was to “finance” general living expenses, then the fact that some of those living expenses might have included everyday repairs and other low-level property expenses would not be what the loan “financed”.

Similarly, on these particular facts, a loan used to finance a divorce settlement which the ex-wife unexpectedly spends on UK property may be thought to be sufficiently distant not to be caught (the position might be different if the divorce settlement specifically contemplated the purchase of a UK house, for instance).

HMRC will take a pragmatic view.

Lenders should make appropriate enquiries and report obvious use of loan-funding, but low-level use which cannot be quantified and more distant use by third parties will not be caught by these provisions. The position for the bank may be more difficult but BPR may often assist on the death of a shareholder.

**HMRC: We agree that there is a practical issue here and that HMRC will take a pragmatic view.**

## **QUESTION 20 – RELEVANT LOAN NOT REPAYED BUT COMPANY SOLD.**

Consider an individual, partnership or trust borrowing to fund a close company which uses the funds to acquire UK residential property. The relevant loan remains outstanding but the individual,

partnership or trust borrower disposes of the company holding the UK residential property rather than selling the house itself and the loan is not repaid? Does the loan remain a relevant loan indefinitely even though no house is in the structure? There seems no provision in the legislation to remove the relevant loan from schedule A1. Para 5 only has a two year rule if the loan is repaid.

#### **Suggested answer**

We would take the view that the loan remains a relevant loan and only when repaid does the two year rule apply.

**HMRC: The loan remains a relevant loan, yes.**

#### **QUESTION 21 – LOAN TO COMPANY (NON-RELEVANT LOAN) REMAINS OUTSTANDING OR IS REPAYED WHERE PROPERTY OR SUBSIDIARY HOLDING PROPERTY IS SOLD**

If there is a loan by an individual or trust to a company X Limited which has acquired another company Y Limited which holds residential property and that Y Limited subsidiary is sold, even if the loan to X Limited remains outstanding, as X Limited is no longer schedule A1 property the loan ceases to be chargeable property immediately and repayment is irrelevant. Do HMRC agree?

#### **Suggested answer**

We agree

**HMRC: The lender no longer has property within Para 2 Sch A1 as a result of the disposal, yes.**

#### **QUESTION 22 – BANKS AND BPR (1)**

It has been pointed out that private closely controlled banks (whether companies or partnerships) that lend to investors in UK residential property can inadvertently be caught by schedule A1. Such loans will often be relevant loans or the bank will be loan participators in the borrowing company. In these circumstances the [foreign] shareholders of / partners in the bank may only be able to rely on business property relief (BPR) to prevent an IHT charge.

We assume that if the bank is carrying on a trade of money lending HMRC will accept that in the normal course of events BPR will be available on any value attributable to relevant loans and that HMRC will apply the relief by looking at the bank's operations as a whole first in determining whether the shareholder is eligible for relief on the transfer of value attributable to non-excluded property.

Please confirm.

#### **Suggested answer**

We confirm that banks with a banking licence or sufficient authorisation to act under its governing law) taking deposits and lending will generally qualify for BPR although of course each case must be looked at on its facts.

There will be no special provisions here so new shareholders and partners will have a UK inheritance tax exposure until the two year holding requirement has been met.

**HMRC: We agree.**

## QUESTION 23 – BANKS AND BPR (2)

A foreign bank may be closely controlled and hold (usually through subsidiaries) relevant loans to third parties to facilitate the latter's purchase of UK residential properties. If the bank would otherwise qualify for BPR on such lending activities, is full relief given even though the bank may separately own an investment subsidiary holding foreign investment property on which BPR would normally not be available by virtue of s111. In other words does BPR have to be tested only by reference to the holding company and the value attributable to the relevant loans or more generally throughout the whole group?

### Suggested answer

We would first ascertain whether the holding company qualifies for relief looked at in the round taking into account s105(3) and then only look at the offending subsidiary in applying BPR rather than examine each separate subsidiary or group activity.

**HMRC: We agree.**

## QUESTION 24 – PARAGRAPH 5 OF SCHEDULE A1- DISPOSALS AND REPAYMENTS: SALES OF SHARES

Without paragraph 5 of Schedule A1, it would be relatively easy to circumvent the legislation in certain deathbed situations. For example, suppose a father wholly owns a company which in turn owns a valuable London flat. The father, aware of his impending death, could give the company shares to his son but this would require him to survive seven years as the property is not excluded property. Instead the father sells the company shares to his son at full market value having first given the son cash abroad (which is a gift of excluded property) to enable the son to purchase the shares. Paragraph 5 aims to prevent this sort of death bed planning. However, paragraph 5 does not deal very comprehensively with what happens in the event that the sale proceeds are mixed with other funds.

### Example 12

A father sells his company shares (the company's only asset being a UK residential property) to his son and puts the proceeds of £1m on deposit in a separate bank account. He then spends the money buying a house in Hong Kong. The Hong Kong house is not excluded property for two years. If the house increases in value only the original sale price is taxed. If the HK property falls in value the lower value is taken.

Do HMRC agree?

### Suggested answer

We agree

**HMRC: We agree.**

## QUESTION 25 – MIXING OF FUNDS FROM SALE CAUGHT BY PARA 5

What would be the position if the funds are mixed with other funds and then some funds are withdrawn and spent. For example, £1m represents the sale proceeds in example 12 above and the balance of the bank account represents £500K which is from an art sale. A withdrawal of £500K occurs. Do HMRC consider that the withdrawal removes the funds pro rata one third from the account so that the £1m is reduced by £333,333 or would HMRC accept that the rule in *Devaynes v Noble* 1816 35 ER 781 better known as the rule in Clayton's Case applies such that the withdrawal is on a first in first out basis?



### Suggested answer

Our preference is that a FIFO basis is used. However, pro rata is acceptable if a FIFO basis is not possible due (for example) to lack of records.

**HMRC: If there is no evidence to the contrary then the FIFO basis is acceptable (so that the withdrawal, here, is not property representing the proceeds).**

### QUESTION 26 – TWO YEAR RULE AND CONTRACT/COMPLETION

It is assumed that the two years runs from the date of the completed disposal or loan repayment not from contract. The CGT rule that the date of contract is the date of disposal is not in point. This raises similar issues to questions 1 and 2.

### Suggested answer

The two years runs from actual receipt of sale proceeds - whether this is from exchange or completion does not matter.

**HMRC: Assuming that you are concerned with disposals of, e.g. shares or relevant loans then we would agree that the receipt of proceeds would start the two-year clock.**

### QUESTION 27 – PARAGRAPH 6 OF SCHEDULE A1– TAX AVOIDANCE ARRANGEMENTS (TAAR)

The draftsman was not content to rely on GAAR but has inserted a specific anti-avoidance provision which is widely drawn.

*“In determining whether or to what extent property situated outside the UK is excluded property, no regard is to be had to any arrangements the purpose or one of the main purposes of which is to secure a tax advantage by avoiding or minimising the effect of paragraph 1 or 5.”<sup>2</sup>*

This therefore catches not only tax avoidance but tax minimisation. It is assumed this would not catch “ordinary” arrangements such as an individual choosing to borrow from a bank to purchase UK property rather than using their own cash resources.

Please confirm.

### Suggested answer

Confirmed

**HMRC: The TAAR rule does include minimisation but without more we would say that in your example the liability is deductible depending upon IHTA s162(5) and the lender has made a relevant loan.**

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<sup>2</sup> IHTA 1984 Sch. A1 para.6 (1).

## QUESTION 28 – ENFORCEMENT AND COLLECTION

Section 237 IHTA 1984 is amended to enable HMRC to impose a charge on the underlying UK residential property. This could bring some odd results.

### Example 13

A mother resident in Hong Kong guarantees a loan from the bank to her son which is made in order to enable the son to buy a property in the UK. The mother gives security to the bank over non-UK investment assets and then dies.

On the death of the mother can HMRC impose a charge over the property owned by the son as security for the payment of IHT on the collateral even though the parent has no interest in the property and is not owed any money by the son and the son may not even inherit anything from his mother?

### Suggested answer

Correct

**HMRC: That is correct.**

## QUESTION 29 – DOUBLE TAX TREATY OVERRIDE AND DEEMED DOMICILIARY

The double tax treaty override in para 7 only applies to the extent a person is liable to IHT by virtue of para 1 or para 5. We assume (as raised previously by ICAEW) that in relation to a person who is already deemed domiciled here and whose interests in foreign companies are not excluded property irrespective of schedule A1, that para 7 has no relevance. The excluded property rules are not disapplied by virtue of paras 1 or 5 but simply do not apply in the first place.

### Example 14

Two brothers Jeremy and John are both foreign domiciled. John is deemed domiciled for UK tax purposes. Both are domiciled in India under common law. Both hold UK residential properties through offshore companies. They are killed in an accident and their non-UK estates are dealt with under Indian Wills. In these circumstances:

- on the death of John (who is deemed domiciled) treaty relief is available to exempt the company shares from IHT because the treaty override in para 7 is not effective for a deemed domiciliary as his interests in foreign companies are not excluded property so Sch A1 is not applicable;
- in the case of Jeremy (who is not deemed domiciled) nothing in the treaty prevents Sch A1 from applying to his interests in the offshore companies since for UK inheritance tax purposes the shares are otherwise excluded property. **A strange way of putting it.**

Please confirm that HMRC agrees with the above analysis.

### Suggested answer

Confirmed

**HMRC: Yes, Sch A1 applies to de-exclude excluded property and John does not have excluded property. So, if John is domiciled in India under Indian law then treaty relief may be available.**

### **QUESTION 30 – ZERO RATE AND DTT**

Where a DTT is applicable but the rate of tax is nil because of say spouse exemption (as with the USA on transfers between US citizens) we assume that para 7 is not intended to disapply relief. IHT is not as such charged at all in these circumstances rather than at an effective rate of zero. The words in para 7(1)(b) could be taken to mean that unless IHT is actually charged but at zero percent DTT does not apply where a chargeable transfer is (say) spouse exempt. In many cases there will just be an exemption and no IHT.

#### **Suggested answer**

We agree that para 7 does not disapply relief in these circumstances

**HMRC: We agree that para 7 does not disapply relief in these circumstances because of the exemption.**

