Inheritance tax: limiting the set-off of debts

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HMRC considers that using debt to buy assets that are not chargeable to inheritance tax allows scope for "two bites of the cherry".

Finance Bill 2013 introduces provisions to counter this planning. In particular, it has a significant impact on:

- non-UK domiciled individuals (and their trusts) who take out borrowings secured on UK assets to reduce their value for inheritance tax; and
- entrepreneurs using their houses as security for borrowings used in their businesses.

Borrowings secured against properties reduce their value for inheritance tax (IHT) purposes, with only the net value being taxable.

Finance Bill 2013 introduces new restrictions on the set-off of such borrowings if the borrowed money is used to buy assets which qualify for IHT relief, or is taken offshore by a non-UK domiciled individual ('non-dom') or the trustees of a trust with a non-dom settlor.

New rules limiting the set-off of debts

The new rules disallow the deduction of some debts in calculating:

- an individual's liability for IHT on their death; and
- trustees' liability for IHT.

Non-UK domiciled individuals

Where a non-dom, or the trustees of a trust set up by a non-dom, incur a liability to acquire non-UK assets, which are outside the scope of IHT, the debt will not be deductible in calculating the non-dom's/trustees' IHT liability.

Where the non-dom subsequently disposes of the non-UK assets and acquires UK assets with the sale proceeds, the liability (or part of it) may become deductible again.

Entrepreneurs

Where anyone incurs a liability to acquire IHT relieved assets such as business property or agricultural property, the debt will be deductible from the relieved assets, rather than from the individual's general estate.

This will impact on entrepreneurs who wish to set up a new business and borrow money against their house in order to finance it.

At present, once a trading company has been owned for two years, it will be exempt from IHT and borrowing taken out to finance the company would be deductible in calculating IHT on the individual's estate if he died. Under the new rules, any debt taken out on or after 6 April 2013 will be deducted against the (exempt) business assets, increasing the IHT payable on the estate. Effectively, the debt will be disregarded.

When do the new rules come into force?

The new rules disallowing the deduction of certain debts will apply where a charge to IHT arises on or after the date on which Finance Bill 2013 receives Royal Assent.

The new rules will apply to all loans taken out by non-doms (or their trustees) to acquire non-UK assets regardless of when the loan was taken out.

However, loans taken out before 6 April 2013 to finance the purchase of business property or agricultural property which qualifies for IHT relief will continue to be deductible in calculating a person's IHT liability.

Examples

Trust established by a non-UK domiciled individual

The trustees of a discretionary trust, set up by a non-dom, hold (directly) a UK house worth £10m.

The trustees are subject to a charge to IHT on UK assets held directly by them on every ten year anniversary of the date the trust was established, and (if the non-dom settlor is a beneficiary of the trust) on the settlor's death.

Previously if the trustees had taken out a loan for £10m, secured on the property and invested the borrowed money offshore the loan would have been deductible against the value of the UK house, so reducing the net value of the UK assets held by the trust to nil.

Under the new rules, the loan will not be deductible so the trustees will be subject to a charge to IHT on the full value of the house.

Non-UK domiciled individual

Frank, a non-dom, owns a UK house (which he holds in his own name) worth £10m. Frank borrows £8m secured on his UK house, and invests it offshore.

As Frank is a non-dom the offshore investments are outside the scope of IHT. He has used the borrowed money to acquire non-UK assets which are outside the scope of IHT and so the debt will not be deductible in calculating the IHT liability on his death.

If Frank invests the borrowed money in the UK he will not have used it to acquire property outside the scope of IHT and the debt will be deductible.

If Frank later sells the UK investments and invests the sale proceeds offshore the debt will only be deductible to the extent that it exceeds the value of the offshore investments.

If instead of investing the borrowed money Frank gives it away, whether or not the debt is deductible may depend or where the gift is made.

If Frank takes out a loan to purchase a UK house and secures the loan on the property that debt should still be deductible in calculating the IHT liability on his death. The new provisions are intended to apply to refinancing, rather than the original purchase.

Entrepreneurs

On 1 May 2013, James borrows £3m against his home (which is worth £5m), to finance his new business venture.

James dies suddenly on 14 October 2016. At the time of James' death the shares in his personal trading company (which are exempt from IHT) are worth £6m and the remainder of his estate is worth £5m. £1.8m of the original loan remains outstanding.

The outstanding debt will be deductible against the value of the shares in his personal trading company (that is, the relievable assets) rather than from the remainder of his estate.

This note is a general guide based on the proposals as at 4 July 2013. It is intended to provide a brief overview only and should not be relied on as legal or tax advice. Specific advice on the particular facts of any matter should be sought.

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