AN INHERITANCE TAX "TRAP" FOR SETTLORS OF NON-UK RESIDENT TRUSTS

Robert Venables QC[1]

The Advantages of Beneficial Loans

It is often considered advantageous for loans on beneficial terms to be made by trustees of non-United Kingdom resident trusts to beneficiaries. Outright payments made to beneficiaries who are United Kingdom domiciled and resident or ordinarily resident in the relevant year of assessment may, by virtue of the Offshore Beneficiary Provisions,[2] involve them in a charge to capital gains tax in respect of gains realised by the trustees of the settlement. Alternatively, beneficiaries ordinarily resident in the United Kingdom may be exposed to an income tax charge under Taxes Act 1988 Part XVII Chapter III (transfers of assets abroad) or Chapter V (offshore funds) if they receive such payments from the trustees.

While the true tax position where an interest-free loan is made is highly controversial, even the Revenue agree that the recipient can be taxed each year not on the face value of the loan but, at the most, on the amount of interest he would have paid the trustees in an arms' length transaction. Such interest-free loans can, even on the Revenue's view, be very useful in spreading a charge to tax over many years.

---

1 Robert Venables QC, 24 Old Buildings, Lincoln's Inn, London WC2A 3UJ
Tel: (0171) 242 2744 Fax: (0171) 831 8095
Consulting Editor of this *Review*.

2 Now contained in Taxation of Chargeable Gains Tax Act 1992 sections 87-98 and discussed in my *Non-Resident Trusts* 5th ed chap 14.

Loans to the Settlor

Some persons have "identified" what they believe to be an "IHT Loanback Problem"[3] where loans are made to the settlor. In their view, Finance Act 1986 section 103 would prevent the deductibility of the amounts owed by the settlor to the trustees in computing the value of his estate for inheritance tax purposes on his death. They therefore conclude that the making of an interest-free loan to the settlor of, say, £10,000 would thus carry with it a potential price tag of, say, £4,000 in inheritance tax.

Let us consider the *ipsissima verba* of Finance Act 1986. Section 103(1) provides:

> "... if, in determining the value of a person's estate immediately before his -death, account would be taken, apart from this subsection, of a liability consisting of a debt incurred by him or an incumbrance created by a disposition made by him, that liability shall be subject to abatement to an extent proportionate to the value of any of the consideration given for the debt or incumbrance which consisted of:
>
> (a) property derived from the deceased ..."

Where the trusts of a settlement are, say, discretionary, then there may be a real problem here. Even in such case, however, provided the debt owed to the trustees were secured, they would be entitled to be repaid that debt in priority to any claim by the Revenue. The Revenue could look only to the personal representatives of the settlor for the inheritance tax on what was in reality a non-existent part of his estate. The personal representatives would be liable to pay the tax only to the extent of the real net assets of the estate. Hence, provided matters were properly structured, there would be no funds left in the estate to pay the inheritance tax, so that the tax charge would be theoretical. For the charge would bite only if and to the extent that there were in reality net assets in the estate. Yet if the settlor is having to borrow from the trustees, it is unlikely that there would be such net assets.

In the case of a trust which is caught by the Offshore Beneficiary Provisions, then in all but exceptional cases or cases where the settlor was badly advised, one will find that *either* the settlor has been excluded from benefit altogether and that no loans are made to him (so as to avoid making all the income arising under the settlement assessable on him under Taxes Act 1988 section 739) *or* the settlor has during his life an interest in possession in the settled property. Now, by virtue of Inheritance Tax Act section 49(1), a person beneficially entitled to an interest in possession in settled property is to be treated for the purposes of the inheritance tax legislation as beneficially entitled to the property in which the interest subsists.

---

[3] Their terminology, not mine.

Here, one must consider the long-established rules relating to the application of deeming provisions in statutes[4] and in particular what was said by Lord Asquith in *East End Dwellings Co Ltd v Finsbury Borough Council* [1952] AC 109:

> "If you are bidden to treat an imaginary state of affairs as real, you must surely, unless you are prohibited from doing so, also imagine as real the consequences and incidents which, if the putative state of affairs had in fact existed, must inevitably have flowed from or accompanied it."

If one applies Lord Asquith's dictum, what is deemed to happen when the settlor in fact borrows money from the trustees? As he is deemed to own the money before it is borrowed, he cannot borrow it from himself. The transfer of the money to himself is a non-event for inheritance tax purposes. His estate is subject to no debt, as a man cannot owe a debt to himself. The question of any such debt being treated as non-deductible in computing the value of his estate for inheritance tax purposes therefore does not arise. Conversely, however, the settled property does not include the right to sue the settlor for the money borrowed, as a man cannot have a right against himself.

The effect of the deeming provision is entirely sensible, in that precisely the right amount is brought into charge to tax on the death of the settlor. If, for example, the trust fund is worth £1,000,000 and the settlor/tenant for life borrows £200,000 and then dies, the trust fund is deemed to be worth only £800,000 as the right to be repaid the £200,000 falls to be ignored. The settlor's free estate has been increased by £200,000 as he has received £200,000 in cash and the liability to repay it falls to be ignored. If the settlor has frittered away the £200,000 in the meantime, with nothing to show for it, then his total estate, actual and deemed, for inheritance tax purposes will indeed have been reduced by £200,000; but that would equally have been the case if he had simply consumed £200,000 of his free estate without any borrowing.

It should be noted that there is no problem under section 103 where the loan is made to the spouse of the settlor. (There may, of course, be other tax consequences of making such a loan.) It is interesting to speculate what the position would be if the spouse were then to make a gift to the settlor.

---

4 The rules were reiterated by the Court of Appeal and the House of Lords, in *Marshall v Kerr*. The judgments are reported at respectively [1993] STC 360 and [1994] STC 638.