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SPECIALTY DEBTS

HMRC is wrong to treat specialty debts as situated where the debtor resides, rather than where the relevant document is found.

Individuals with a foreign domicile are only exposed to IHT in respect of assets situated in the UK. In general terms, assets situated outside the UK are excluded property – and outside the scope of the tax. Accordingly, identifying where an asset is situated is rather important.

Specialty debts – generally those due under a deed – are regarded as situated where the document is physically located. This has been the common law rule for centuries and has been acknowledged clearly by HMRC in its *IHT Manual* (IHTM 27079. Not anymore. HMRC now says that this interpretation is unlikely to be correct and specialty debts should be treated for inheritance tax purposes as situated where the debtor resides, to correspond with the general rule which applies for simple debts.

There has been lots of indignation about this, but HMRC is perfectly entitled to change their view. It does not mean they are right – indeed, I would suggest they are wrong. Either way, there are now likely to be many arguments (and probably litigation) before the position is clarified. We can no longer rely on HMRC to accept the common law rule.

Although this is extremely important for inheritance tax, it may not be of such significance for other taxes. There are statutory rules for the situs of debts for capital gains tax in TCGA 1992 s 275 and liability to income tax depends on the broader concept of source – whether the income arising has a UK or foreign source. That is normally found by the application of the guidelines in the celebrated case of *Nat West Bank v National Bank of Greece* (1970) 46 TC 472.

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Complications can arise where the instrument is located in a territory which does not recognise deeds, or if the debt is charged on land – but HMRC does not address these points at the moment. They are expressing a more comprehensive view that it is the residence of the debtor which determines the situs of a debt (specialty or otherwise) for IHT purposes.

(This change in the view of HMRC resonates with some changes proposed in the Finance Bill to amend the rules relating to withholding tax. The draft clauses provide that in determining whether yearly interest arises in the UK for the purposes of deduction of tax, no account is to be taken of the location of the deed under which the interest is payable.)

Even if HMRC is right, it will no doubt be claimed that they are bound by their previous interpretation and the number of judicial review applications will get even greater. However, that is only likely to be relevant to people who have already died or have made transfers of specialty debts. Those in possession of such debts would have no such protection. They now know that HMRC take a different view and can have no legitimate expectation that HMRC will regard them as situated abroad.

It will be necessary for foreign domiciled individuals with specialty debts located abroad (and trustees who may, on HMRC's new interpretation, be subject to a ten year charge) to consider how to protect themselves. Some may take a robust (and perhaps optimistic) view that HMRC will back down in due course. Others may take a more cautious approach and transfer the debts to a foreign incorporated company to secure excluded property status for the future. That would be fine for IHT but could have capital gains tax consequences if for example the debt was denominated in a foreign currency.

One might wonder why HMRC decided to take this approach and challenge such long established authority when it may have been easier to change the law instead. No doubt this will be revealed in due course – when the arguments begin in earnest. *HMRC's change in view is set out in its IHT Manual at IHTM 27079, 27080 and 27091.*

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