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TAXING MATTERS

Peter Vaines ponders on specialty debts

IHT : specialty debts

Individuals with a foreign domicile are only exposed to IHT in respect of assets situated in the UK. 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 under seal – are regarded as situated where the document is physically located. This has been the common law rule since practically the dawn of time and has been acknowledged clearly by HMRC in its manuals. Not anymore. HMRC now says that this interpretation is unlikely to be correct and that specialty debts should be treated for inheritance tax purposes as situated where the debtor resides, corresponding with the general rule which applies for simple debts.

There seems to be lots of indignation about this, but HMRC is perfectly entitled to change its view. It does not mean it is right—indeed, it is probably wrong. Accordingly, there is now likely to be lots of arguments (and probably litigation) before the position is clarified. We can no longer rely on HMRC accepting 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 specialty debts for capital gains tax in s 275, Taxation of Chargeable Gains Act 1992 (TCGA 1992) and liability to income tax depends on the more broad 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 case of *Westminster Bank Executor and Trustee Company (Channel Islands) Limited v National Bank of Greece SA* (46 TC 472).

This change in the view of HMRC resonates with some changes proposed in the Finance Bill. The draft clauses impose an obligation to deduct tax from yearly interest arising under specialty debts, even if they are located abroad, if the interest would otherwise have a UK source.

Even if HMRC is right, there will no doubt be an insistence that it is bound by its previous interpretation on the basis of a legitimate expectation. That seems irresistible, except that is only likely to be relevant to people who have already died or have previously made transfers of specialty debts. Those in possession of such debts now know that HMRC takes a different view and can have no 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 the 10-year charge) to consider what to do to protect themselves. Some may take a robust (and perhaps imprudent) view that HMRC is wrong and will back down in due course. Others may 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.

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