Analysis

Inheritance tax and the requirement to correct

Speed read

The requirement to correct (RTC) regime imposes significant new penalties for failing to correct any offshore tax non-compliance for periods up to 5 April 2017 before 30 September 2018. The scope of RTC is wide and applies not only to income tax and capital gain tax, but also to inheritance tax. Historic IHT liabilities could be unexpectedly caught by RTC, for example in EBT settlements where income tax liabilities have been agreed with HMRC but IHT has not been considered as part of the settlement, or where it could be argued that there is an additional settlor(s) unbeknown to trustees. Trustees, settlors and beneficiaries correct historic issues in the most appropriate way, for example by using HMRC's worldwide disclosure facility.

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Finance (No. 2) Bill 2017 introduced the requirement to correct (RTC) regime. The rules are not in fact a requirement to correct but impose significant penalties for failing to correct any 'relevant offshore tax non-compliance' relating to periods up to 5 April 2017, within a period which began on 6 April 2017 and ends on 30 September 2018.

The scope of the legislation is very wide and applies not only to income tax and capital gains tax, but also to inheritance tax (IHT). For IHT purposes, 'offshore tax non-compliance' includes a failure to file and the delivery of an incorrect return. For the penalty to apply, the tax non-compliance must involve an offshore matter or an offshore transfer.

IHT, particularly as it applies to non-UK resident trusts, is one of the more complicated and less well understood areas of UK taxation. This article discusses some relevant examples where historic IHT liabilities could be unexpectedly caught by RTC, and offers some practical advice to help advisors and taxpayers identify any areas of possible risk, and correct historic issues in the most appropriate way before the regime comes into effect in October 2018.

A failure to correct: assessment time limits and penalties

For IHT purposes, the measures will apply to all relevant tax non-compliance relating to 5 April 2017 and earlier, for which HMRC could have lawfully assessed at 17 November 2017 (the day after royal asset of F(No. 2)A 2017).

The time limits for IHT differ significantly from those applying to income tax and capital gains tax and can be found at IHTA 1984 s 240, as amended by FA 2009 Sch 51. Where an account has been delivered, HMRC can 'look back' 20 years where there has been deliberate behaviour, six years for careless behaviour and four years for innocent behaviour, from the later of the date on which the last payment was made and accepted, or the date on which the tax became due. However, where no account has been submitted or where there is an omission from the account, the assessing period extends to 20 years from the date on which the tax became due, unless the loss of tax is brought about deliberately, in which case there is no time limit.

To give HMRC more time to open enquiries and raise assessments, a special statutory extension allows any tax years still assessable under existing statute as at 5 April 2017 to remain assessable until at least 5 April 2021. This means that where there is a careless or innocent error relating to an omission on an IHT account, it will be possible for HMRC to assess back to 1997; and if the error was deliberate, there are no time limits.

If a failure to correct is identified, the starting position is that the taxpayer will be liable to the following penalties:

- The taxpayer will face a penalty of 200% of the potential loss of revenue (PLR). This can be mitigated but not below 100%.
- A further asset based penalty of up to 10% of the value of relevant offshore assets may apply where the PLR exceeds £25,000.
- An enhanced penalty of 50% of the amount of the standard penalty may apply if HMRC can show that assets or funds had been moved in an attempt to avoid the RTC rules.
- The taxpayer's details can be published where the PLR exceeds £25,000.

Given the widely drawn scope of RTC and the severe consequences of failing to correct, it is important that trustees, as well as settlors and beneficiaries, and their advisers consider how these new rules impact them. We will now take a look at some situations where there is potential for IHT issues to arise.

Excluded property trusts

Under IHTA 1984 s 48(3)(a), property held in a trust situated outside the UK is excluded property unless the settlor was domiciled in the UK at the time the settlement was made. Importantly, this means that provided the property itself is situated outside of the UK, there will be an exemption to UK IHT charges.

Thus, it is vital that trustees of a trust who believe the assets held to be excluded property ensure two things:

1. the settlor(s) were in fact non-domiciled (and not deemed domiciled) at the time of the settlement; and
2. their understanding that the assets are not UK situated is accurate.

A failure to meet either of these two conditions will mean that an IHT charge may have arisen.

Status of the settlor

Determining the domicile position of the settlor(s) may not be a simple task. Domicile is a subjective general law concept with no single, simple legislative test. In assessing the position, trustees may be reliant on the information they are provided with either by the settlor or perhaps his other advisors. In the context of RTC, this can present significant challenges.

Consider the situation where trustees are informed that the

settlor of the trust is not domiciled in the UK and therefore understand the property comprised in the trust to be excluded property. On this basis, the trustees would not calculate tax or submit an IHT account on the ten year anniversary principal charge date, or at an exit, provided of course there were no UK situs assets.

If HMRC successfully challenged the domicile status of the settlor and concluded he was UK domiciled, the trust would thus contain relevant property; and consequently IHT would be due on the ten year anniversary and at each subsequent anniversary. In this situation, although HMRC has challenged the settlor's position, it is the trustees who will have a liability. There would also be exit charges on distributions. The assessment time limits which apply for IHT mean that even though the trustees accepted the domicile position in good faith, they would be liable for IHT in respect of any chargeable event dating back to 1997, as well as late payment interest and FTC penalties.

The domicile status of a settlor is something which trustees should be mindful of not only at the date of settlement, but also at any point when additional property is settled. This has been an ongoing issue of debate; see for example in *Barclays Wealth Trustees (Jersey) Ltd v HMRC* [2015] EWHC 2878 (Ch) and [2017] EWCA Civ 1512. HMRC is likely to take the view that settlor status at the time of any additional property is likely to be relevant to the tax position. Thus, even if the trustees have taken advice on this point, they need to ensure that it is relevant, up to date and meets the requirements for defending penalties under RTC.

There is one potential defence to the FTC penalties: that the trustees had a reasonable excuse for their failure. The reasonable excuse defence is narrowly drawn and the legislation specifically states that where the taxpayer relied on any other person, that cannot be reasonable excuse unless the taxpayer took reasonable care. In the context of the above example, it may be possible for the trustees to argue that they have reasonable excuse if they had been provided with copies of a professional opinion as evidence of the settlor's domicile position. However, the position may be less clear if the trustees had merely accepted a statement as to the domicile status without seeing any relevant advice.

Further, there are provisions within the legislation which limit the taxpayers' ability to rely on advice; this is particularly relevant where the advice has not been given to the person concerned, or where the advisor was also involved in setting up the arrangements. A fuller examination of the application of these measures is outside the scope of this article but it is clear that the trustees need to consider carefully what they will be relying on if they subsequently need to defend the position they have adopted.

As well as confirming their understanding of the domicile position of the trust's settlors, trustees would be advised to check their understanding of who all the settlors are. IHTA 1984 s 44(1) provides a wide definition of 'settlor' to include 'any person who has provided funds directly or indirectly for the purpose of or in connection with the settlement or has made with any other person a reciprocal arrangement for that other person to make the settlement'. Trustees may therefore have to consider not only the position of the settlor as stated in the trust deed, but also the wider circumstances surrounding settlement and whether in reality there was another person who could be considered a settlor for UK IHT purposes who was not detailed as such in the trust instrument.

Situs of assets

The situs of property is another key issue for trustees. In many cases, the situs of an asset may be easily identified, but sometimes the situs may not be clear and a detailed analysis of the general law or a double tax treaty may be required. However, even where the situs of the asset may be clear, the trustees will also need to have recognised not only the significance, but the existence and the value of a holding of UK assets at the relevant time. This might be difficult where trusts hold investment portfolios with a wide variety of assets which change on a regular basis, which can make keeping track of the situs of assets particularly difficult.

The changes to the non-domicile regime which made indirect holdings in UK residential property UK sited for IHT purposes will further complicate matters, but as these only take effect from 6 April 2017 they are outside of the scope of RTC. Nonetheless, in undertaking their RTC review, trustees may well find it helpful to consider these additional points for the future.

Employee benefit trusts

In recent years, employee benefit trust (EBT) structures have been subject to significant scrutiny by HMRC and there have been a number of changes to legislation (particularly a number of amendments to the disguised remuneration provisions at ITEPA 2003 Part 7A). Although the principle focus of this activity has been on income tax issues, there are some significant IHT issues for trustees to consider.

Broadly, where the conditions at IHTA 1984 s 86 are met, property settled on an EBT will not be regarded as relevant property and will be exempt from, for example, ten year anniversary charges. However, the provisions at s 86 are prescriptive and require that the settled property is held on trust for 'all or most' of the employees of an entity. As a result, HMRC argues that property held on sub-funds for the benefit of a specific employee, or his or her family, will not meet the conditions at s 86 and will therefore be subject to IHT charges. In many cases, EBTs will have made loans to individual employees or their family members. The right to recover a loan will be an asset of the trust for IHT purposes.

Trustees of EBTs will need to carefully consider whether any IHT charges have arisen, particularly in light of HMRC's increasing pursuit of these issues. Trustees who believe they have a defensible position will nonetheless need to ensure that they have appropriate advice to defend RTC penalties. Trustees should also take care that any settlement agreement which is reached in accordance with HMRC's EBT settlement terms unambiguously addresses the IHT issues.

Action points

There is a need to act quickly, given that the RTC window closes in September this year. Some key points to consider are:

- Trustees and clients with offshore interests should review their affairs to ensure there are no errors or omissions.
- Where the right amount of tax has not been paid, a disclosure should be made to HMRC as soon as possible. Options include HMRC's digital disclosure service (the worldwide disclosure facility) or any other service provided by HMRC as a means of correcting tax non-compliance, amending an existing tax return or delivering a new tax return.
- Documentation, particularly that which shows professional advice suitable for defending RTC penalties was sought, reviewed and addressed appropriately, should also be maintained. ■

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▶ The requirement to correct (Helen Adams & Dawn Register, 6.9.16)