Neither a borrower nor a lender be

Borrowing and lending is, of course, fine if it's tax-efficient. *Julie Butler* reviews the pitfalls that the tax adviser faces

Every organisation will have to look carefully at cash flow management throughout its business life, dealing with 'cash mountains', controlling distributions and commercial borrowings. Each individual sole trader, partner, shareholder or investor has to look at their own tax position, and this includes inheritance tax (IHT) relief.

Although the focus of the business has to be commercial, the recent case of *Executors of Rhoda Philips v HMRC* [2006] WTLR 1280 has illustrated the need to ensure that all loans are ideally IHT-efficient for Business Property Relief (BPR), while also achieving maximum corporation and income tax relief. Can this present a conflict of interest?

The facts of the case

When Rhoda Phillips died in June 2001, she owned 245,000 shares in PPI Investments, but HMRC determined that they did not qualify for BPR. Ms Phillips' executors appealed, and the Special Commissioner was called on to determine whether PPI's business consisted 'wholly or mainly of ... making or holding investments' under *IHTA* 1984, s. 105(3).

Ms Phillips was a widow, and she held a majority shareholding in PPI, a company that lent money to related family companies. Her executors claimed BPR. HMRC rejected the claim on the basis that PPI's business consisted mainly of making or holding investments under s. 105(3).

The case emphasised that for BPR purposes in such circumstances, it is important to look at the activity of the business at date of death and two years before, and not at the activity the business undertook in the past. Thus, the fact that until 1989 the company had been a property investment business was not relevant to the current claim for BPR.

The business of making loans

The ultimate finding of this case was that money lending is a trading activity. The Commissioner did not regard the activities of a money-lender as investment and allowed the executor's appeal, finding that PPI was a banking arm for in-house transactions. On the evidence, PPI was in the business of making loans and not in the business of investing in loans. The loans were not investments for their own sake but the provision of a finance facility to the other companies. Accordingly the shares in PPI qualified for BPR.

Deathbed loan-planning

The allocation of secured borrowings is essential planning to protect against the potential IHT liability that might arise if the borrowings are not allocated correctly. When reviewing the potential IHT liability of property and the related borrowings at the date of

death, there is no requirement for a liability to have been secured on a particular asset for any particular length of time. The appropriate arrangement of borrowings can lead to 'deathbed' tax-planning, though of course any rearrangement of borrowings must be completed before death.

'Wholly and exclusively' linking with security

The aim of every business is to achieve maximum tax relief on borrowing.

Income and corporation tax relief is given for interest paid on borrowings incurred 'wholly and exclusively' for the purpose of a trade. Similar rules apply for borrowings to finance a rental business. This tax relief on interest payments is therefore given according to the purpose of the loan, whereas for IHT purposes a loan is matched with the assets on which it is secured or charged.

An anomaly of the different taxes is that the loan can be for the purpose of purchasing one asset and it can be secured against a totally separate asset. It is often beneficial for IHT purposes to secure a loan on assets that do not qualify for any IHT reliefs rather than business assets. Thus the business assets' value is increased and therefore so is the BPR claim, while the IHT-vulnerable assets are reduced by the borrowings. The tax planner must consider whether a conflict of interest arises in trying to juggle income tax, corporation tax and IHT relief. Who is the client? Who is seeking advice? Who is giving the instruction? Sole traders do not present such a problem, but companies and partnerships can require either disclosure of the potential conflict or that alternative independent advice be sought.

Pre-deathbed loan-planning

Deathbed loan-planning certainly has a part to play in IHT planning, but clearly long-term restructuring and possible refinancing should be put in place at an early stage to ensure that maximum tax reliefs are achieved. For example, it might be that corporation or income tax relief is available on loan interest where tax relief might not have been previously allowed or might have been disallowed because it was not wholly and exclusively for the purpose of the trade. In an ideal world all clients should undergo a 'loan management' tax review or audit.

Re-allocating borrowings: APR v BPR

A review of the tax efficiency of loans that would result in the reallocation of borrowings should not give rise to CGT problems. There are important differences between APR and BPR in the context of borrowings. Under *IHTA* 1984, s. 110, for the purposes of BPR the value of a business or an interest in a business is to be taken as the net value, ie, the value of the assets used in the business reduced by the aggregate amount of liabilities incurred for the purposes of the business, regardless of the security given.

APR is restricted to 'agricultural property' and loans secured on it. As defined by *IHTA* 1984, s. 115 (2), agricultural property means agricultural land or pasture and also includes such cottages, farm buildings and farmhouses, together with the land they occupy, as are of a character appropriate to the property.

When looking at reallocating borrowings it is also imperative to review excess cash balances (the 'cash mountain'). The potential future claim for BPR or APR must therefore be assessed when looking at the borrowings structure to ensure maximum benefit is achieved.

The IHT requirement for the cash mountain

It is equally important to ensure that any excess cash deposits are protected by an IHT claim. It has to be shown to be for future use. *The Barclays Bank Trust Company Limited vs IRP* [1998] SSCD 125 (SPC C158) highlights this.

The question was whether a £300,000 'cash mountain' that a company held was an excepted asset under *IHTA* 1984, s. 112 (2) and therefore did not qualify for IHT relief. The facts were that the deceased died in November 1990, holding 50% of the shares in a company; her husband held the other 50%. The company sold bathroom and kitchen fittings, mainly to the trade. The cash position was strong. The company did not tie up working capital either in premises (which were occupied rent-free and which belonged to the deceased) or in stock. The company's cash at bank and in hand in 1990 was more than £450,000. Cash was invested for periods of up to 30 days. Turnover was around £600,000.

In February 1990 the company approached a similar company and expressed an interest in buying that company's properties. The other company did not reply and was later liquidated. In 1997 the original company spent more than £355,000 on a venture in the purchase of goods imported from China.

HMRC accepted that the company needed £150,000 in cash at the death of the deceased, but subsequently issued a Notice determining that £300,000 was not so required. The appellant, executors of the deceased, appealed.

The decision was that on the evidence of the facts presented, the £300,000 was not required for the purposes of the business. An asset did not cease to be an excepted asset because at the time of the deceased's death it might be required at any time in the future. 'Required' in *IHTA* 1984, s. 112(2)(b) did not include the possibility that the money might be required should an opportunity arise to make use of it in two, three or seven years time for the purposes of the business. Some imperative was implied that the money would fall to be used on a given project or for some palpable business purpose. There was no evidence on the facts that the company was to be the purchaser of the other company's assets. The money was not 'required'. The appeal was dismissed.

The message to the tax planner is that for IHT relief to be achieved, cash surpluses must be required for future use *and* there must be evidence to support this. If there is no argument to support future use then an alternative should be considered.

Alternative uses for the cash mountain

What are the alternatives? For example, to repay family or group borrowings if appropriate, loan-planning must also incorporate a review of cash balances to see where repayment can be achieved and improve potential IHT relief for the owners of the business. Cash mountains could be taken from the incorporated business and invested in 'IHT-efficient investment products' to prevent them being caught under s. 112.

There are schemes available that effectively allow the donor some measure of income stream without apparently contravening pre-owned assets or gifts with reservation of benefit legislation.

Repaying, borrowing or even achieving IHT relief as a money lender as in the *Phillips* case appears more capable of achieving the risk management tests. It is essential that written confirmation of the availability of IHT relief is obtained, and ideally a copy of the supporting tax counsel's opinion.

Loans to traders

Loan to traders that are not repaid can achieve CGT relief. When organising loan management, it is also essential to understand the ability to claim this CGT relief under *TCGA* 1992, s. 253. The tax case of *Daniel Conrad Crosby and others vs Broadhunt* (Spc C416 19.5.04) showed that the claim does not have to be made at the point the loan is waivered and released.

The facts were that H Ltd was a trading company that had been lent money on two occasions by the trustees of a settlement that E had made. By 1991, it had total debts of over £2 million, including the aggregate £250,000 owed to the settlement. The Revenue accepted that the loans were then irrecoverable. The shareholders were able to secure a sale of the company to its then managing director and an outsider, neither of whom was a member of the settler's family. The sale was completed in March 1992. One condition of the sale was that the trustees should execute a deed of waiver and release of the loans, and this was done.

However, H Ltd continued to decline and it entered into receivership in 1993.

The settlement's 1992-93 tax return included a claim for a capital loss of £250,000. The inspector refused the claim, based on the view that, at the time of a claim for relief, the loan must still be in existence, ie, it must not have been at this point written off, waivered or released; the trustees appealed.

The taxpayers' argument was based on the purpose of the legislation, which related only to a limited class of loan, ie, those made to traders. It could be deduced that it was intended to encourage such loans by allowing the lender relief if the borrower became unable to repay the loan. The Revenue's interpretation of s. 253 (3), that the loan must still be in existence at the time the claim is made, was unwarranted. It was clear in this case that at the time the claim was made the loans had become irrecoverable and the waiver did not affect that position. It did not cause the irrecoverability, nor would the loans have become recoverable again had there been no waiver.

The Revenue's opinion was that the statutory words were clear. The use of the words 'has become irrecoverable' necessarily implied a continuing state of affairs. They gave as an analogy the sentence 'My cat has become ill': one would not use that form of words if the cat had since recovered, or died, but only if the cat was alive and unwell.

What did the Commissioners decide?

The Commissioners returned to the Revenue's cat. While it is right that one would not say 'My cat has become ill', one might say 'My cat has become ill and has recovered several times'. The latter sentence implies no continuing state of affairs. The semantic subtlety on which the Revenue's argument depended had to be treated with some caution.

The Commissioners agreed instead with a point the taxpayer made: that if Parliament had intended that a loan must be both subsisting and irrecoverable, it would have been simple to say so. The appeal was allowed.

It is hoped that, now that the Revenue and Customs have merged, the cat is still alive and well...

The tax-planning key is to review all loans to traders that might not be recovered, and ensure that maximum CGT relief is obtained if appropriate.

Professional logistics of financial planning

There are a number of logistical problems surrounding tax planning, planning around the subject of borrowings, money lending and cash mountains in the form of the Financial Services Act.

First, many small businesses do consider it appropriate to involve their tax adviser in the borrowing arrangement, and sadly seek tax advice in a retrospective manner. Second, the advice can be defined (or considered to be defined) as the provision of financial services, and some firms are concerned over the understanding of their professional code of conduct and the problems this might create. Third, at large firm level the corporate finance departments are totally dedicated to corporate efficiency but not so aware of, for example, the IHT considerations. There could also be a conflict of interest between the corporate tax-planning advice where the client giving the instructions is the company and the shareholder (who needs the IHT advice) is a conflicting client interest. Likewise, in a partnership where the tax adviser is appointed and instructed by the partnership to advise on the income tax efficiency of loans, the adviser has to consider the individual partners' IHT position. If they are conflicting, the tax planner must identify the conflict or suggest alternative independent advice.

Restriction of investment advice

A new code of ethics issued by the ICAEW identifies just who accountants (and tax advisers bound to this code) can refer their client to.

Members of the ICAEW have a completely new professional code of ethics from September 2006, which now takes into account changes in the provision of financial services advice and the introduction of the Insurance Mediation Directive. The updated code, which is available on the ICAEW website, highlights the need for members to fully understand the nature of the referral they are making and whether or not their authorisation means they can actively make a referral or whether they are restricted to a more passive referral style by providing information only.

Section 241, *Agencies and Referrals*, highlights that referrals should only be made where the status of the investment adviser is compatible with the overarching requirement 'to give objective advice'. The tax-planning work regarding business cash flows can move over to the domain of investment advice, and complying with the appropriate code of ethics is essential.

Conclusion

So many angles of financial planning for the business are based on immediate need – 'asset needed now: obtain instant borrowings'. The cash flow tax audit is an essential way forward subject to the restrictions I have set out above.

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