

# the knowledge



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June 2007

## what exactly is Phizackerley?

The recent Phizackerley case means clients will need to take care when making funds available to a beneficiary by way of a loan from a trust. **Colin Jelley** gives details.

There seems to be a constant flow of news about inheritance tax (IHT) planning and the various schemes available in the market place. Following this year's Budget, we now have clarity on bare trusts for minors and additional HM Revenue & Customs (HMRC) guidance notes on the popular discounted gift schemes. However, the recent Phizackerley case opens up another series of questions.

The case is well reported, but in principle relates to a main residence scheme where an 'IOU' or debt was intended to arise on the first death of Dr and Mrs Phizackerley. In this case, Mrs Phizackerley died first and a debt, to the value of her half share in the property was created – a common approach.

I do not propose to critique the actual case (a full breakdown is available via [www.financeandtaxtribunals.gov.uk](http://www.financeandtaxtribunals.gov.uk)) but to show how this decision, which it seems may not be challenged, impacts on our day-to-day business. The key point to address is that HMRC did not challenge the use of a debt or 'IOU' but rather the original source of the funds.

For clarity, the debt type scheme has been far more popular in recent years as opposed to actually leaving the half share of the property on the discretionary trust. This is due to the issue over capital gains tax principal private residence relief and, more importantly, the concern that this actually created an interest in possession if the surviving spouse still occupied the property.

### section 103 FA 1986

The legislation which HMRC used to challenge the taxpayer, and defend their position that tax was payable on the estate with no relief available for the debt, is over 20 years old. The relevant law is Section 103 FA 1986 'Treatment of certain debts and incumbrances', as follows:

*103 (1)...if, in determining the value of a person's estate immediately before death, account would be taken... 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... which consisted of... property derived from the deceased.*

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## how does this apply to the case?

The principle to consider here is that the half-share of the house, left on Mrs Phizackerley's death to her trustees, actually came from Dr Phizackerley. Despite severing the tenancy on their property and establishing correctly worded wills, the property purchase was only funded by Dr Phizackerley, as Mrs Phizackerley never worked.

This means that the half-share of the house exchanged for the debt was actually 'property derived from the deceased' and hence there is no relief for the debt against Dr Phizackerley's estate.

Although this legislation is not new and the principle described in the case is straight forward and well understood, the application of this law to these property structures is novel. The approach adopted by HMRC means that when recommending any type of trust the source of the funds is extremely important, not only at the point of establishing the trust, ie own bank account or funds, but at the original source.

For example, due to personal taxation, married couples may well move money

between each other to manage their tax affairs. When considering a debt scheme, future planning strategies need to take into account the fact that a non-working spouse may never have worked and may be without any other sources of income and capital.

## identify the 'Phizackerley challenge'

Discretionary will trusts are a core part of initial IHT planning for many people. One of the key benefits is that access for the surviving spouse can be achieved without the trust forming part of their estate. Rather than receiving capital, trustees may decide to make payments in the form of loans. If spent, these loans will effectively reduce the taxable estate of the surviving spouse as they will create a debt against their estate on death, provided the surviving spouse had not made substantial gifts to the deceased spouse. This type of planning is also available on most lifetime discretionary trust wordings and is something that should be considered.

Going forward, advisers should ensure that they clearly identify any previous substantial gifts between spouses and make certain the risk of any similar 'Phizackerley challenge' is minimised.

## summary

When considering a new trust following the recent changes to IHT, there is already a new order of events in which to establish multiple trusts to minimise the impact of the discretionary trust regime. This case will remind us all that we need to look closely at what has gone before and situations where a challenge relating to s103 FA 1986 is a concern.

The IHT planning arena continues to present opportunities for new and existing trusts. 'IOU' and debt type schemes are particularly popular with solicitors drafting wills and may already be in place, but should now be reviewed.

With a wasted nil rate band potentially costing a client £120,000, clearly establishing where appropriate funds have come from could save significant amounts of tax in the future.

The Phizackerley case highlights how the need for advice and closer working relationships with you and your clients' other professional connections continues to grow. ■

This article is based on Skandia's interpretation of the law and HM Revenue & Customs practice as at 31 May 2007. We believe this interpretation to be correct but cannot guarantee it. Tax relief and the tax treatment of investment funds may change.

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FSA Register number 110462