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HMRC's Treatment of Specialty Debts: An Update

H.M. Revenue and Customs have now amended their manual to resile slightly from their previously combative stance on the tax treatment of specialty debts. However, it is clear that HMRC still consider the special treatment of such debts potentially open to challenge.

While no legal justification has yet been provided for this change of approach, any planning utilising specialty debts should nonetheless be treated with caution.

What is a specialty debt?

A "specialty debt" is a debt, contract or obligation that:

- is executed as a deed; or
- is incurred under statute; or
- is a debt of the Crown.

Ordinarily, debts are deemed to be enforceable in the jurisdiction where the debtor resides. However, it is a long-established principle of the common law that the situs of a specialty debt (i.e. its location for legal purposes) is the place in which the document recording that debt is physically situated.[1]

Use of specialty debts in IHT planning

Specialty debts are particularly useful when planning for UK resident non-domiciled individuals, as well as for UK resident beneficiaries of trusts with a non-UK domiciled settlor.

By ensuring that the deed recording a specialty debt

is physically stored outside the UK, it has previously been possible to ensure that the debt itself will be treated as "excluded property" and so fall outside the scope of the charge to UK inheritance tax ("IHT") for non-domiciled and non-deemed domiciled individuals.[2] For example, life insurance policies taken out by UK resident non-doms have often been executed as deeds and held offshore to ensure that their proceeds should not be subject to IHT (for as long as they also remain non-UK deemed domiciled for IHT purposes).

Rationale for the Treatment of Debts

In the past, the courts have suggested that specialty debts qualify for distinct treatment on the basis that they are "of a higher nature" than ordinary debts. Indeed, the Privy Council has noted that the "act of creating a specialty was at one time possible only to men of the highest rank". [3]

It has been suggested that specialty debts are treated as having a quasi-metaphysical "species of corporeal existence in the sealed instrument" which justifies the link between the location of the debt and that of the instrument recording it.[4] As James Kessler QC notes, these assertions do not provide a terribly satisfying justification for the survival of this treatment into the modern era.[5]

However, the rule does have a solid practical justification: it ensures that it is clear and simple to ascertain where a specialty debt can be enforced by a creditor. It was noted in Commissioner for Stamps v Hope that "residence is of ...a changeable and fleeting nature" but that by treating a debt as having a corporeal existence linked to the instrument in which it is recorded "its locality might be reduced to a certainty".[6]

The earliest records of this treatment of specialty debts emerge from the Elizabethan ecclesiastical courts, where it was held that "the debt is where the bond is, being upon a speciality; but debt upon a contract follows the person of the debtor". Even at this early stage, the privileged status of specialty debts was stated to have been "oftentimes agreed". [7]

Although such cases were originally concerned with "bona notabilita" (i.e. whether certain assets were within the scope of the local court's jurisdiction for probate purposes), the clarity and simplicity of the rule have seen it survive into the modern era as an accepted principle of the common law. [8]

HMRC's Approach

Prior to January 2013, HMRC's approach to specialty debts had followed the accepted common law position, stating in their Inheritance Tax Manual that "a specialty debt is situated where the instrument happens to be".

On 24 January 2013, HMRC unilaterally announced a change of practice without prior warning and in the face of established case law. The relevant chapter of the Inheritance Tax Manual was amended to state that:

"In the past, HMRC's approach to the situs of specialty debts has been that this depends on where the relevant document is found. We have now been advised that our previous approach is unlikely to be correct. We now believe that these debts are situated where the debtor resides". [9]

Perhaps in light of the scathing response from certain parts of the legal profession, HRMC has again amended its guidance. The relevant chapter of the manual now states that:

"In the past, HMRC's approach to the situs of specialty debts has been that this depends on where the relevant document is found. We now believe this may not be the correct approach in all cases involving specialty debts; specifically that many such debts are likely to be located where the debtor resides, or where property taken as security for the debts is situated. Any cases involving situs and a specialty debt must be referred to Technical. For example, any claim that a debt secured on UK assets is not UK situs property must be sent to Technical". [10]

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Although HMRC are now only claiming that the special treatment afforded to specialty debts "may not be the correct approach in all cases", they still consider that "any cases involving situs" may be vulnerable to a challenge. It seems likely that HMRC may attempt to assert that the situs of any "property taken as security" – presumably, particularly that of UK real property against which a specialty debt is secured – determines the situs of a given debt and not its specialty status.

Opinion is divided as to whether HMRC's position is correct: nonetheless, the revised manual is clearly intended to act as a deterrent to any UK tax planning using specialty debts.

The Current Position

Any attempt by HMRC to apply their new position retrospectively should be open to challenge on the basis that their previous position was stated in published manuals, and taxpayers should have a legitimate expectation that HMRC should act in accordance with its publicly stated position.

At the present, the risk of challenge by HMRC may make use of specialties unattractive. Advice should be sought regarding any existing planning utilising specialties. In some cases, it may be possible for steps to be taken to escape the need to rely on the specialty debt rules in avoiding exposure to IHT.

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This article offers general guidance only. It reflects the law as at October 2014. The circumstances of each case vary and this article should not be relied upon in place of specific legal advice.

1. Halsbury's Laws of England Vol. 19 (2011) 5th Edn.at paras 682-683.
2. See s 6(1) Inheritance Tax Act 1984, which states that "property situated outside the United Kingdom is excluded property if the person beneficially entitled to it is an individual domiciled outside the United Kingdom".
3. R v Williams [1942] AC 541 at 555.
4. Halsbury's Laws of England Vol. 19 (2011) 5th Edn. para 682.
5. James Kessler Taxation of Non Residents and Foreign Domiciliaries (12th edn.) (2013) para.82.13.2.
6. [1891] AC 476 at p 481; the situs of a specialty debt is complex where the debt is secured against land c.f. John Rimmer, "Specialties and the New HMRC Approach to Situs" Private Client Business 2013, 4, 179-185.
7. Per Anderson, J in Byron v. Byron Cro. Eliz. 472.
8. James Kessler TNRFD (12th edn.) para. 82.13.2; see also, for example, Arvind Mills Ltd., Ahmedabad vs State Of Gujarat And Ors (1966) 0 GLR 156; Blackstone v. Miller, 188 U.S. 189 (1903).
9. H.M. Revenue and Customs, Inheritance Tax Manual ("IHTM") 27091, (February 2006) and IHTM 27079 (January 2013), both reproduced in Kessler TNRFD (12th edn.) at paragraph 82.13.3.
10. HMRC IHTM 27079 < http://www.hmrc.gov.uk/manuals/ihtmanual/IHTM27079.htm> accessed at 12:28 pm on 4 November 2013.