THE ART OF THE POSSIBLE[1]

Robert Meakin[2] and Mary Ambrose[3]

Part 1: Giving your Art Collection Away But Still Enjoying It — Charitable Options

by Robert Meakin

1. Introduction

This paper focuses on how high net worth individuals can donate their precious art collections and houses to charities in a tax efficient way — yet still, to a certain extent, retain possession of their property. *Part one* looks at charitable giving, while *Part two* looks at non-charitable options and compares them to the suggestion made in part one that a settlor could establish his own charity, transfer his art collection to it but continue to enjoy possession of the collection. Alternatively, the settlor could enter into arrangement with existing charities such as museums and galleries on favourable conditions. Although the paper's focus is on art, it also necessarily covers situations where both art collections and the property housing the collection are vested in a charity.

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1 This paper was first published in 2008 as a special report by the European Association of Planned Giving and is reprinted with their kind permission. E-mail: info@plannedgiving.org.uk www.plannedgiving.org.uk. The report revises and updates a previous paper on the subject – see "The art of the possible - Part I" by Robert Meakin [2002] CL&PR 7/3, 177-186 and "Giving away your art collection – Part II" by Mary Ambrose [2002] CL&PR 7/3, 187-200.

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2. A Settlor's Own Charity

Before looking at how a settlor having transferred ownership to the charity can continue to enjoy possession of his collection and the relevant tax reliefs, it is necessary to set out the requirements of charitable status.

2.1 Charitable Basis of an Art Collection

The charitable basis of an art collection is to advance the education of the public[4]. To be charitable in law there must be benefit to the public. In other words there must be sufficient educational value or artistic merit and, in addition, sufficient public access given. Following the Charities Act 2006 which abolishes the presumption of public benefit for inter alia, educational charities there will be a greater scrutiny as to whether charities have satisfied the public benefit test.

2.2 Educational Value?

A charity established to display paintings of little or no artistic merit would be unlikely to be considered to be charitable in law by either the Court or the Charity Commissioners.

In one famous case *Re Pinion*[5] the testator gave his studio, paintings, old furniture, silver and other objects to his trustees to offer to the National Trust. He left the rest of his estate as endowment to maintain the collection as a museum should the National Trust decline the gift (which it did). Expert witnesses agreed that the collection was of a low quality and that it had no educational value. The Court of Appeal decided, on the basis of the experts' evidence, that the gift was not charitable because it lacked educational value. Lord Justice Harman commented as follows[6]:

> '*I can conceive of no useful object to be served in foisting upon the public this mass of junk. It has neither public utility nor educational value*.'

The traditional approach of the Charity Commissioners when looking at applications for charitable status is to take expert evidence on educational value when educational value is not obvious.[7] This is confirmed by the review of the register document RR10 'Museums and Art Galleries'[8]. An example from practice involved some debate over the registration of a leading contemporary art charity until the

4 See "Museums and art galleries", RR10, Charity Commission, 2002.

5 [1965] Ch 85.

6 *Ibid*. at 107.

7 Expert evidence was admitted in *Re Pinion.*

8 http://www.charity-commission.gov.uk/publications/rr10.asp

matter was decided by expert evidence. The evidence of at least two experts is usually required by the Charity Commissioners. The initial decision as to whether educational value is sufficient is often subjective and only resolved by such expert evidence.

2.3 Public Access?

In order to be charitable there must be sufficient public access. Where charities are set up to house art collections they must be available to the public and not just exclusively enjoyed by the donor. For example, a private hobby which purely benefits the person collecting the art and is not available to the public is not charitable. A case from practice involved the rejection of hand painted public house signs because they were regarded as a private collection.

The Approach of the Charity Commissioners to Public Access

Public access usually means physical access but in the Charity Commission review of the register document 'Preservation and Conservation'[9], which sets out its current position on public access, the Charity Commission has gone on record as saying that in appropriate cases it will allow computer simulations, videos and TV and radio coverage etc.

Traditionally the approach of the Charity Commissioners was as follows:

(a) If a work of art is of only scholastic interest then it may be restricted to visits by appointment by academics.

(b) If the work of art is of exceptional quality and would be damaged if brought out of storage too often then restricted access may be permissible.

(c) Otherwise, reasonable public access can be by prior appointment. Reasonable public access by appointment means 7 days a week for 6 months a year (with reasonable exceptions) or exceptionally 3 months a year at 7 days a week (this is sometimes referred to as The National Trust criterion). The Charity Commission usually expects public access to be given at weekends and bank holidays to allow working members of the public the opportunity to visit.

2.4 A settlor must divest himself of the collection

The general rule is that the settlor (i.e. the person placing the paintings into charity) must fully divest himself of his gift. In other words he must transfer legal ownership

9 "Preservation and conservation", RR9, Charity Commission, 2002. See *www.charity-commission.gov.uk/publications/rr9.asp*

of the paintings to the charity. That is not to say that the gift cannot remain in his physical possession and continue to be enjoyed by him.

2.5 Rule against trustees benefiting

The general rule is that a trustee cannot benefit from his/her office as a trustee without specific authorisation from the charity's governing instrument or the Charity Commissioners. The benefit in this context is private enjoyment of the paintings. Unless the Charity Commissioners specifically authorise a settlor or members of his/her family to act as trustees, independent trustees will need to be appointed. Having said that, where a settlor is providing the funds or property for the charity, such as an art collection, and provision is made in the governing instrument for the settlor as trustee, or family member trustees to receive benefits the Charity Commissioners have in the past had no objections to those arrangements so long as the overall public benefit of the gift is maintained. However, RR9 'Preservation and Conservation' points out the need to avoid potential conflicts of interest through provisions in the charity's governing instrument which ensure that former family owners who remain in possession of charity property such as works of art or buildings only form a minority of the Trustees and absent themselves from meetings when they are in conflict.

2. Advantages for the Settlor

As mentioned above, the general rule is that charities exist for the public benefit rather than the private benefit of any individuals. If the paintings and property housing the paintings are made available to the public, then any private benefit to the settlor in terms of enjoying the paintings in his home for the rest of the time may be viewed by the Charity Commissioners as incidental to that public benefit and therefore acceptable.

Charges by the Settlor or the Charity?

3.1 Settlor

It is probably permissible for the settlor to charge the charity for security costs, lighting and maintenance on a pro rata basis.

3.2 Charity

It is probably also permissible for a charity to make a reasonable admission charge to the public to assist in paying for the pro rata maintenance charge by the settlor and to restore the paintings.

However, should the benefits to the settlor, arising from the charges outlined above, outweigh the overall public benefit to the charity then registration as a charity may be provisionally rejected and if the charity is already on the register of charities then it could be investigated by the Charity Commissioners.

4. Reservation of benefit: Inheritance Tax Charge?

Usually, owners of paintings with charitable intentions might consider retaining the collection during their life and then bequeathing the paintings to a charity on their death; such a disposal would be free of both inheritance tax and capital gains tax.[10] However, some people prefer to dispose of their collection of paintings during their lifetime, often for philanthropic reasons or perhaps to transfer the paintings to their own charity during their lifetime, so that they have the opportunity to be actively involved in the charity.

4.1 Paying Rent Instead of Giving Public Access

A few years ago a story emerged in the national newspapers concerning Andrew Lloyd-Webber's charity. Lord Lloyd-Webber (as he now is), his wife and a business associate were trustees of the charity. The press claimed that for almost half the time, when the charity's paintings were not on loan to public galleries, they were housed in Lord Lloyd-Webber's home without public access. The main legal issue was whether there was a breach of the public access rule.

In this case the Charity Commissioners had authorised the arrangement between the charity and Lord Lloyd-Webber so that Lord Lloyd-Webber only had the paintings while they were not on loan to public galleries and he paid the charity a rental for their use during the period of time that they were in his possession. Therefore, in return for rental payments to the charity the Charity Commissioners agreed that public access could be denied. Lord Lloyd-Webber had also purchased a painting from the charity but at a price above market value. Furthermore, even though the level of public access would normally be insufficient in this case the charity recovered the benefit of rental payments which could be used to purchase more paintings. There was no reservation of benefit for the purpose of inheritance tax because full consideration was given by Lord Lloyd-Webber.

4.2 Retention of the House and Collection

Property can either be held by a charity as functional property i.e. to house the art collection or alternatively as part and parcel of the charitable objects. If a charity is established to preserve and maintain a particular property for the benefit of the

10 See section 23 Inheritance Tax Act 1984 and section 257 Taxation of Chargeable Gains Act 1992.

public then sufficient public access needs to be given (as described above) and the quality of the building needs to be sufficiently high. Quality could be established by either English Heritage listing of I (exceptional) or II (more than special interest) or through a connection with a particular person or historic event.

A case from practice, involved a world famous architect who conveyed his paintings and house to a charitable trust. In this case his wife was allowed to remain in sole occupation without public access to the house because she was elderly and her life expectancy was not long. In order to avoid inheritance tax she would have needed to pay a full market rent. This was said to be an exceptional case by the Charity Commissioners and HM Revenue & Customs (HMRC) , and charitable status and inheritance tax relief were awarded on that basis.

An alternative arrangement could involve the settlor occupying part of the house and retaining part of the collection. This would usually be a separate compartment of the house, not open to the public, which is relatively unimportant and would not detract from the overall public benefit. That part of the house could contain some paintings subject to agreement with the Charity Commissioners.

This would usually involve a lease by the occupant to the charity for a market rent with the obligation for the tenant/occupant to pay insurance and maintenance for part of the house that he or she occupies. There would be no inheritance tax to pay if a full market rent was given.

4.3 Cash Gifts to a Charity Which Then Buys Paintings

It might be possible for a settlor to make a cash gift to a charity whose trustees buy paintings. This arrangement might avoid a charge to inheritance tax[11]. From an inheritance tax perspective, the settlor cannot transfer works of art if the transfer does not have immediate effect, if it depends on a condition which will definitely not be fulfilled within 12 months or if the transfer can be revoked. However, a letter of wishes from the settlor to the trustees to purchase paintings might be acceptable. So long as public access is given a settlor can enjoy the paintings. The danger is that HMRC might attack the arrangement as being preordained.

5. New Substantial Donor Rules

The Finance Act 2006 introduced several anti-avoidance measures in relation to charities. One of the new measures introduces provisions that target 'substantial

11 See section 23 Inheritance Tax Act 1984. A lifetime cash gift is not eligible for Gift Aid relief where the gift is associated with the purchase of property from the donor – see section 416(6) Income Tax Act 2007.

donors' receiving inappropriate benefits[12]. Charities need to be careful that they are not caught by these provisions as there are potential tax and charity law consequences. The substantial donor rules need to be considered in the context of this paper. It should be noted that HMRC are currently carrying out a consultation on proposals to mitigate the full effect of these rules and therefore they might shortly change with a view to ensuring that they exempt all transactions that a charity has cause to carry out in the course of its charitable activities and to minimise the administration burden for charities.[13]

In order for the new provisions to take effect there must be:

5.1 A substantial donor

A 'substantial donor' is someone (a company or individual) who gives a particular charity £25,000 in any year or £100,000 over a period of 6 years. The monetary limit relates to the value of gifts made and includes not only cash gifts but also, amongst others, gifts of shares and assets otherwise subject to capital gains tax. Once a person qualifies as a substantial donor for any chargeable period they remain classified as such for the following five years.

5.2 An Applicable Transaction

An 'applicable transaction' includes[14]:

- the sale, letting or exchanging of property between a charity and a substantial donor;
- the provision of services between a charity and a substantial donor;
- provisions of financial assistance between a charity and substantial donor; and
- investment by a charity in the business of a substantial donor.

The consequence of a charity being caught by these provisions is that if the transaction involves the charity paying the substantial donor, an amount of the charity's income equivalent to the payment will be taxed. If the charity is receiving money or benefit then any difference between the actual terms and what HMRC consider would be 'commercial' terms will be taxable on the same basis.

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12 Section 54 Finance Act 2006.

13 See "Substantial donors to Charity. A review of anti-avoidance legislation around large donors to charity", HMRC, 15 July 2008.

14 See s506A Income and Corporation Taxes Act 1988 and s549 Income Tax Act 2007.

These provisions dovetail with another change brought in by section 55 of the Finance Act 2006 which means all non-charitable spending will incur loss of tax relief on a £1 for £1 basis (there was previously an allowable limit of £10,000).

5.3 Example

One year Charity *X* receives a donation of painting valued £30,000 from Mr Donor via Company *A*, which he owns. As part of an informal arrangement, in return, Charity *X* leases an art gallery to Mr Donor at £75,000 per year (which is only 75% of its commercial value). Under the new rules Charity *X* would be taxed on the £30,000 value of the painting - Mr Donor qualifies as a 'substantial donor' by virtue of being a connected party to Company *A*. Given 30% corporation tax rates, this could mean the charity being liable to a £9,000 tax charge. In addition the trustees of Charity *X* could be held to be in breach of their duties by virtue of allowing the charity to incur non-charitable expenditure.

5.4 The aim of the measures is to target tax avoidance and not to penalise legitimate commercial or charitable transactions.

Accordingly there are exceptions to allow for applicable transactions to be exempt if they are done in the course of the business of the substantial donor and on fully 'commercial' terms. Equally, where a charity provides benefits or money to a substantial donor, there is an exemption if the charity is pursuing its primary purpose and is providing the benefit on the same terms as provided to others. Remuneration paid by the charity to a donor does not break the rules if the Charity Commission or the Court has given authorisation. Also where HMRC is satisfied that the arrangement is not part of an arrangement for the avoidance of tax the rules will not be breached.

6. Conditional Gifts and Loans

6.1 Gift Subject to Conditions

A settlor may wish to attach particular conditions to his gift when transferring his paintings to either his own charity or an existing charitable institution such as a public gallery or museum.

As a matter of law when property, such as paintings, is donated to a charity subject to particular conditions then, depending on those conditions, a separate charity may be created. Those charities are often referred to as 'special charitable trusts'.

If paintings are given to an institution, such as a gallery, subject to a condition or conditions that those paintings shall be held by the institution on special charitable trusts, then legally (depending on the exact terms of the gift) the institution may act

as a trustee of a separate charity. Institutions such as The Tate Gallery and the Victoria and Albert Museum hold collections of art and artefacts on special charitable trusts. A donor wishing to ensure that his collection was preserved for the benefit of the public might be comforted by the fact that his collection was held separate from an institution's general assets which could more easily be sold or made available to creditors in an insolvency situation.

Sir Denis Mahon recently withdrew three old Masters from the Walker Art Gallery in Liverpool as a result of the decision by the National Museums & Art Galleries Commission on Merseyside to impose admission charges. The paintings were given to the Walker Art Gallery on the condition that they should be available for the public free of charge. His success in withdrawing the paintings demonstrates the value to donors of making conditional gifts to institutions.

6.2 Ensuring that the collection is not sold by the Trustees

Often settlors will wish to ensure that once their collection of paintings is transferred to their charity that the Trustees do not then sell their paintings. This consideration is relevant, irrespective as to whether the settlor wishes to transfer his paintings to his own charity or an existing instrument.

As a matter of law, if the objects of the charity are expressly for the public exhibition of paintings or a specific collection of paintings then subject to there being an express power in the charity's governing instrument to sell the paintings the Trustees may, if they consider it to be in the best interests of the charity, sell the paintings. However, on the other hand, if the charity has broad charitable objects and the settlor transfers paintings or a collection of paintings to the charity then arguably each painting or alternatively the collection of paintings as a whole is held on separate charitable trusts, with the effect that, in the absence of an express power of sale set out in the instrument of transfer, authority would be required from the Charity Commissioners by way of an order or a scheme, in order to sell the paintings.

In order to put the matter beyond doubt settlors would be wise to establish the charity with broad charitable objects and then transfer the paintings or collection subject to conditions that the paintings or collections are held *in specie* for retention in perpetuity as permanent endowment. This would have the effect of creating special trusts for the paintings or collections, making it clear that there was no express power of sale and in the case of the requirement that the paintings are held as permanent endowment that should the paintings ever be sold then the proceeds of the sale must be held as capital. The requirement that the paintings be held as a permanent endowment would deter the Trustees from seeking to sell the paintings and expend the funds generally.

The effectiveness of the special trust device as a deterrent on trustees from selling works of art were shown by the attempt by the Royal Holloway and Bedford New College to sell three minor works of art[15] . The Charity Commissioners took the view that, although the paintings were held on special trust, the College held the paintings as an adjunct to its primary educational object for the adornment of the College and could therefore be sold. Significantly the paintings were not held for public display.

However, in stating that the case was not to be seen as a 'green light' for other charities to sell their paintings the Charity Commissioners distinguished charities which had as their objects the display of works of art and other charities with educational objects which held the paintings on special trust for the decoration of the charity's building. It should be noted that it took four years for the scheme to be sealed and come into effect.

6.3 Loans

A private charity can make loans to museums, galleries, universities and schools, all of which are open to the public or a sufficient section of the public for the purposes of charity law, without breaching the public access rules. Typically a loan agreement will be put in place providing that the borrower will pay the cost of insurance and other related costs.

7. Dual-qualified UK/USA charities

Where a settlor is a non-UK domiciled US citizen resident in the UK with a collection of paintings and income in the US and the UK then it might be wise to structure the charity as a dual-qualified UK/USA charity.[16]

This is a charity which is structured so that it qualifies as a charity in both the UK and USA. In the UK only cash gifts given by gift aid and donations of certain kinds of shares can attract tax relief for the individual donor. In the UK gifts of works of art to a charity are treated on a no loss no gain basis and are exempt for inheritance tax purposes. However, in the USA a non-cash gift such as a work of art can be deducted against income tax up to the **full value** so long as it is used for the objects of the charity which would need to be related to the artwork. A dual-qualified charity might therefore allow donors to give tax efficiently in both jurisdictions.

For example, if a non-domiciled US citizen is resident in the UK and has paintings in both the US and UK and wishes to donate some paintings to his US and UK

15 See Decisions of the Charity Commissioners, Volume 1

16 See 'Transatlantic Charitable Gifts' by Richard Cassell, Christie's Bulletin, Vol 1 Issue 5 at p.2,, Autumn 1995 and the updated article in Vol. 5 No 2 at p.25, Winter 2000.

charities this might be a useful tax planning device. If he donates his US paintings to his UK charity then he will face a significant US tax on the capital gain on the appreciation in the value of the painting. For US income tax purposes his basis in the paintings will be his purchase price since there will have been no step-up in the basis at the time of the gifts. In addition, he will not be able to deduct the value of the paintings against his income tax and may face a US gift tax liability.

If, on the other hand, he donates his UK paintings to his US charity then any appreciation in value since the date of purchase will result in a UK capital gains tax liability. An inheritance tax liability could arise in connection with the donation as well.

The use of a dual-qualified UK/US charity can eliminate these problems of taxation and offer the non-domiciled citizen resident in the UK the opportunity to deduct the value of his gift of paintings against his US income for tax purposes and to avoid tax on any gain. Essentially this will enable the US citizen resident in the UK to achieve the same tax results as his UK citizen counterpart.

8. Gift Aid and Admission Fees

8.1 Introduction

It would be open to a charity owning heritage property or art to charge admission fees to members of the public. The question arises: can this admission fee be gift aided? The law relating to Gift Aid and admission fees has recently changed[17]. As of 6th April 2006, the option for heritage and conservation charities to simply treat admission fees as Gift Aid payments has ceased. Under the new law qualifying charities will still be able to claim Gift Aid on admission fees although only if certain new conditions are met.

8.2 Re-cap of previous position

Under the previous law certain heritage and conservation charities could offer free admission to view their property/wildlife in return for a Gift Aid donation, without the admission being considered a benefit for Gift Aid purposes (this was an exception to the general principle that a benefit to the donor will invalidate a Gift Aid payment). In effect this allowed such charities to treat admission fees as Gift Aid payments, and accordingly claim back the extra 22% from HMRC.

17 See section 11 Finance (No. 2) Act 2005.

8.3 The new provisions

The new measures will continue to allow certain charities (as set out paragraph 8.5) to treat admission fees as Gift Aid payments, although new conditions must first be met. The conditions are either:

(A) the admission fee must grant the right of entry for a period of at least a year (i.e. annual membership fees can be treated as Gift Aid); or

(B) the amount of the gift must be at least 10% greater than the regular admission fee which must be available as an alternative.

For example, under the new provisions a charity with heritage properly or works of art could offer the following options to customers wishing for admission to view its property[18]:

- Annual membership: £40 (which could be treated as Gift Aid)
- Admission fee: £10 (which could not be treated as Gift Aid)
- Gift Aid donation: £11 (all of which could be treated as Gift Aid)

8.4 Practical considerations

Charities will have to give thought as to what the likely take up of the new alternatives will be and set their prices accordingly. For example, if paying 10% more than the current admission fee is too prohibitive, the admission fee may have to be lowered so that the Gift Aid option can be lowered making it more attractive. The benefits for getting individuals to pay the extra 10% are considerable – charities will not only gain the 10% up front, but are also able to recover an extra 22% of the gift from HMRC.

In the pursuit of encouraging individuals to pay the extra 10% charities may wish to point out that higher rate tax payers will be able to claim tax relief on 18% of the gift, as is the case with all Gift Aid payments. To continue the above example, a higher rate taxpayer would be able to claim £2.20 (20% of £11) as tax relief meaning that the actual cost to such a visitor would be £8.80 – i.e. cheaper than the ordinary admission fee; meanwhile a charity with heritage property or works of art would receive £13.42 in total (£11 +(22% of £11))[19]. Whether higher rate tax payers

18 For details of HMRC's interpretation of these rules see section 3.48 of the Guidance Notes on HMRC's website www.hmrc.gov.uk/charities/guidancenotes.

19 The basic rate of income tax reduced from 22% to 20% with effect from 6 April 2008, but charities are entitled to claim a supplement based on the 22% rate on donations made in a transitional period of 3 years ending on 5 April 2011.

will bother to remember such small payments is doubtful, but then they might be more inclined to make annual Gift Aid payments which could be worth claiming.

8.5 Who will be able to benefit from the new provisions?

The previous provisions could only be used by conservation or heritage charities who are granting a right of admission to view property whose preservation and conservation is the sole aim of the charity.

The new provisions extend to charities *granting admission to the public to view property preserved, maintained, kept or created in pursuance of charitable purposes - including buildings; grounds; plants; animals and works of art.* This is significant as the provision now relates not only to property being preserved or conserved but in addition to property "*maintained, kept or created*". Furthermore, the preservation, maintenance etc. of such property does not have to be the sole aim of the charity, rather it need only be carried out in pursuance of its general charitable purposes.

For example, under the previous provisions an independent school (which is a charity) could not claim Gift Aid on an admission fee relating to the right to view its gardens as the preservation of the gardens are not the sole/main purpose of the charity. However, under the new provisions such a school will be able to do so as it will be maintaining the property in pursuance of its general charitable purposes. This will give donors greater choice in selecting charities to donate works of art and heritage property to or to come to other arrangements.

PART II: Giving Your Art Collection Away But Still Enjoying It — Non-charitable Options
by Mary Ambrose

1. Introduction — the Tax Consequences of Keeping an Art Collection within the Family

If you own valuable chattels or real property then you may be worrying about inheritance tax on your death which is charged at 40% above the nil rate band (£312,000 for 2008/09).

The solution may be to give away the chattels/real property to children. This would be potentially exempt from inheritance tax and, entirely exempt if you survived the gift by 7 years. However, from a capital gains tax (CGT) point of view, the gift would be a disposal triggering a tax charge of 18%. There is a specific chattels exemption from capital gains tax for individual chattels worth up to £6,000, and an annual exemption of £9,600.

However, this paper does not explore giving art away completely, but giving it away and still being able to enjoy it.

From an inheritance tax point of view this creates problems. If a father gives away his valuable collection of 16th century masterpieces to his son but still continues to hang them on the wall of his home then what are known as the gifts with reservation of benefit rules come into play[20]. These treat any assets which you have given away while retaining anything more than a minimal benefit over them as still within your taxable estate and so within the charge to inheritance tax.

Since the Finance Act 2004 there has also been a further exposure to tax when chattels which you once owned are given away but where you still enjoy some sort of benefit from them. These are known as the pre-owned assets rules and work by imposing an annual charge to income tax on the value of the chattels[21]. If you have reserved a benefit over assets or if the assets are still regarded as being in your inheritance tax estate then you can elect for these rules not to apply, but they were brought in as a loophole-plugging exercise to make sure that tax could not be avoided by giving away assets but continuing to enjoy them in some way.

20 See s102 and Sch 20 Finance Act 1986.

21 See Sch 15 Finance Act 2004.

What happens if you keep the artworks until you die and pass them via your will to your children or relations? Inheritance tax would be charged at 40% above the nil rate band, but from a capital gains tax point of view there would be an uplift in value to the value at death so that it would be unlikely that your heirs would have to pay any capital gains tax.

There are a number of possible solutions to these difficulties, which are explored below.

2. Solution One – Conditional Exemption from Inheritance Tax

One solution to this inheritance tax problem is to use an exemption specifically designed for museum quality artworks and historic houses – *conditional exemption*[22]. This exemption has a very long history – exemption from estate duty (the forerunner of inheritance tax) was first introduced in 1896. Successive governments have realised that it is vital to preserve fine art and heritage property and to prevent it from being sold overseas or fragmented in order to pay large death duty bills. It obviously makes sense for the state to encourage private owners to carry on looking after art collections and the houses in which they are kept rather than for this burden to fall on government.

Conditional exemption from inheritance tax works by affording exemption from the inheritance tax which might have been due on the value of heritage chattels and historic houses in exchange for an undertaking that these assets will be preserved in good condition, retained in the UK, and that the public will be given reasonable access to see them. This acts only as a deferment of tax so if the assets are subsequently sold or the undertaking broken in some way then the inheritance tax charge is recaptured.

2.1 Tightening up of the Conditional Exemption Regime

Leading up to the general election in 1997 there was a lot of controversy about these undertakings. It was a Labour Party manifesto pledge that the conditional exemption regime would be overhauled and that the undertakings would be tightened up[23]. What had been happening in some instances was that the tax relief had been granted but owners were offering very restricted access. It was alleged that the regime was very secretive with little information available about the assets or how one might get to view them.

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22 See ss.30-35A Inheritance Tax Act 1984.

23 In 1994 the Labour Party issued a policy document "Tackling tax abuses – Tackling unemployment" which promised to reform the law relating to conditionally exempt artworks.

The result was a considerable tightening up of the rules concerning undertakings and public access in the Finance Act 1998. First, the quality standard for the exemption of assets was raised much higher. Second, the level of public access to exempted property generally was opened up and the required degree of publicity about the assets and how to view them was increased. One particularly contentious aspect of this new regime was that HM Revenue and Customs (HMRC) were given power to reopen the terms of undertakings which had already been settled.

2.2 Property eligible for Conditional Exemption

Categories of property eligible for conditional exemption:

- Chattels eligible on their own merits – pictures, prints, books, manuscripts, works of art, scientific objects or a group of such chattels which are pre eminent (i.e. of museum quality) for their national scientific historic or artistic interest (pre-1998 they just had to be of national scientific historic or artistic interest)

- Land of outstanding scenic, historic or scientific interest with ancillary buildings

- Buildings which are of outstanding historic or architectural interest

- Amenity land which is essential for the protection of the character of the outstanding building

- Objects which are historically associated with an outstanding building

2.3 Undertakings

What sort of undertakings might you be asked to make? Undertakings will be:

- To keep the asset permanently in the UK

- To implement agreed steps to preserve the asset

- To implement agreed steps for securing reasonable public access – it is no longer possible to restrict this to access by appointment only – access might mean a long term or temporary loan to a public collection or display in a privately owned house which is routinely open to the public. If the asset is displayed on private premises not routinely open to the public then HMRC might require anything from 5 days to 100 days public access per year with a norm of 25 days. For owners with a large number of exempt items it might be better to display them in a purpose built private museum for an agreed period each year. Owners are entitled to charge a fee for viewing the

objects so long as this is reasonable. Owners can ban photography and ask for ID if they are worried about security.

- To publish details of the undertaking and other information relating to the exemption. Apart from a ban on publishing personal and sensitive information contained in exempted documents HMRC can insist on disclosure being made of every aspect of the exemption claim. A summary of the undertaking will be entered on the HMRC website and the owner will have to provide any member of the public who asks for one with a copy. Owners wanting to protect their identity can appoint an agent such as a solicitor to deal with enquiries from the public.

2.4 Maintenance Funds

As well as giving exemption from inheritance tax on heritage property itself it is also possible to ring fence capital from inheritance tax by putting it in a maintenance fund associated with the preservation and upkeep of an outstanding building or land. The fund can also be used to facilitate public access. Normally there is complete exemption from inheritance tax on the transfer of assets to a maintenance fund and no charge during the life of the fund so long as the trustees apply its assets exclusively towards meeting the primary heritage objectives[24].

One example which was in the news in 2006 is Cawdor Castle in Nairn, Scotland made famous in Shakespeare's *Macbeth*. A recent case in the Scottish Court of Session[25] involved a dispute between the 7th Earl of Cawdor and his step-mother the Dowager Countess Cawdor. He sought to have his step-mother removed as one of the trustees of the Cawdor Maintenance Trust because he felt she was using the fund for her own benefit. He objected to her spending £39,000 on her private rooms in the Castle and to the fact that £16,000 had been loaned to a charity set up to repair the nearby ruined Lochindorb Castle. He further alleged that she had wrongly spent £50,000 on repairing a bridge to cut her car journey between her private home and the Castle.

The Cawdor Maintenance Trust was set up in 1984 while the 6th Earl was still alive. However, Cawdor Castle itself is not in the trust which is owned by the Dowager Countess personally. The Castle and grounds and ancillary buildings are conditionally exempt from inheritance tax. Prior to his death the 6th Earl granted a lease of the Castle to a company called Cawdor Castle (Tourism) Ltd which exploited the Castle as a tourist attraction. That lease was terminated in 2003 and since then the tourist potential has been exploited via Cawdor Castle Limited with the Dowager Countess as the Managing Director. The Court found in favour of the

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24 See s27 and Sch 4 Inheritance Tax Act 1984.

25 *Petition of RH Colin Robert Vaughan 7th Earl of Cawdor and others* [2006] CSOH 141.

Countess on all counts as all the items of expenditure complained of were permitted under the trust deed.

3. Solution Two – Business Property Relief from Inheritance Tax

Another solution apart from conditional exemption (or indeed in addition to conditional exemption) is to make use of business property relief for inheritance tax to prevent a large tax bill on heritage chattels and buildings. If you can show that you are exploiting the chattels and or buildings for business purposes then business property relief can reduce the inheritance tax take by as much as 100%. To qualify, the property in question must be "relevant business property". This applies to any property which consists of a business or an interest in a business, any unquoted shares or securities in a business, controlling interests in quoted shares, as well as any land or building, machinery or plant used wholly or mainly for the business. The relief reduces to 50% where controlling interests in quoted shareholdings, plant, machinery or land and buildings are concerned. If the business involves dealing in shares, land or the making or holding of investments, then the relief is not available. A further restriction applies to assets which are not used wholly or mainly for the purposes of the business and are not required at the time of the transfer for the purposes of the business. If you open your historic house containing heritage chattels to the public in the expectation of making a profit then it can be classed as a business.

One example of a historic house for which business property relief was claimed is Ragley Hall near Birmingham. This was the subject of a case before the tax tribunal, the Special Commissioners, in 2004[26] . The Hall was vested in the 8th Marquess of Hertford. The Hall is open to the public as a business. The exterior is accessible to the public to view as a whole but only part of the interior (about 78%) is open to the public. The remaining 22% was occupied by the Marquess and his family as their private residence and was closed to the public. In 1991 the 8th Marquess transferred the business to his son and the son took over the 22% of the house as his private residence in turn. Part of this was rented back to the 8th Marquess until he died in 1997. This meant that the transfer of the business to the son became potentially chargeable to inheritance tax because the father had died within seven years of making the gift. However, the business qualified for business property relief. HMRC argued that the executors of the 8th Marquess couldn't get 100% relief for the value of the whole freehold because of the 22% of the interior which was not open to the public. However, the Tribunal found in favour of the Marquess's estate because it was impossible to consider Ragley Hall as anything other than a single asset. The Hall was plainly property consisting of a business and the whole building was a vital backdrop to the business carried on. The whole of the exterior was essential to the business.

26 *Ninth Marquess of Hertford v IRC* [2005] STC (SCD) 177.

4. Solution Three – Gift and Leaseback

The third solution covered in this part of the paper is the possibility of giving away your heritage chattels and buildings, but then leasing them back at full market rent. This enables you to get round the gifts with reservation of benefit rules – there is a specific carve out for lease backs at market rent – and the pre owned assets tax – again it doesn't apply where a market rent is paid for use of a chattel or building. However, this sort of arrangement can be very fiddly and it is vitally important to be able to show that the rent you are paying for the asset is at market value.

How do you work out what the market rent would be for leasing a chattel? In most cases there is no realistic prospect of obtaining a cash rent for chattels. The most you might expect would be that the person who is using the items will provide secure storage and underwrite the costs of conservation and insurance. However, a convention has arisen that the market rent is between 1% and 2% of the capital value of the items you are enjoying. HMRC have argued that those renting chattels should be paying a higher percentage but this has not succeeded.

If you give some pictures to your son and then rent them back at market rent the rental income will be taxed in your son's hands. It may be more tax efficient to capitalise the rent and make a one off payment. This would be free of income tax in the lessor son's hands and would reduce the value of the donee parent's estate for inheritance tax. Where a house and the chattels in it are given away and rented back this could be arranged under a furnished letting agreement. The annual rent payable on this is unlikely to be enhanced by reference to the value of the chattels which would result in a lower rent being payable. However, the big caveat with all these suggestions is that you would have to get an experienced surveyor involved to make sure that what you were paying could be seen as the market rent.

It is certainly advisable to:

- Get an experienced valuer involved on the current valuation range for chattels.

- Supply any expert with all the necessary information, such as cost of insurance and conservation and details of any circumstances which might enhance or diminish the enjoyment of the donor/borrower.

- Record all negotiations over the lease.

- Get an actuary involved for each party if you decide to capitalise the rent to ensure that the final figure is arrived at on arm's length terms.