HIGHLIGHTS OF "TAX PLANNING FOR HIGH NET WORTH INDIVIDUALS"

A Key Haven conference held on 5th December 2006

Speakers:
Andrew Thornhill QC (1)
Robert Venables QC (2)
James Kessler QC (2)
Amanda Hardy (2)
Timothy Lyons QC (2)
Richard Vallat (1)
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(All statutory references are to the Inheritance Tax Act 1984 as amended unless otherwise stated)

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I Strategies for Directors and Employers - Andrew Thornhill QC

- **First Year Losses**

There will be many instances where expenditure of a speculative nature will create a first year loss then be recovered by later profits or a capital sale. The latter is preferable because it will usually benefit from CGT business asset taper relief ("BATR"). Beware FA 2004 s.126 ff where the trade is exploiting a licence.

- **Secondment of Staff**

Employer seconds staff to Non-Resident Company who hires them back to the employer for a fee. The fee includes a sum for bonuses or an Employment Benefit Trust ("EBT") contribution. If the contribution is made by Non-Resident Company, it should not be caught by anti-avoidance provisions in Sch 24 FA 2003. Points to watch: (1) Employer must not impose conditions; (2) agency provisions need care; (3) Non-Resident Company must not have a UK permanent establishment.

- **Holding Company and Subsidiaries**

If Holdco makes contributions for the benefit of its subsidiaries employees, Sch 24 does not apply. This will not help employees of Holdco. Consider perhaps Holdco having corporate directors. Points to watch: (1) do not recharge subsidiaries in case the recharge is caught; (2) Holdco can claim the payment as management expenses. Sch 28 AA ICTA 1988 could apply. Let it apply and create a notional deduction in the subsidiaries.

- **Benefits from EBTs** – Andrew considers these are still tax efficient, in particular:

  - *No inheritance tax* – IHTA s.86 and with particular reference to family companies;

  - *Qualifying Loans* are generally free of all tax;

  - *Sub-trusts* can be created for particular employees. Is s.86 still satisfied? – normally yes, if the sub-trust is revocable.

Many EBTs fall outside ss. 86, 87 TCGA 1992 – offshore arrangements.

- **Alternative to Options** – Andrew considers the following possibilities:

  - EBT acquires shares and creates an equitable charge over them to secure a certain sum.

  - The interest in the shares subject to the charge is appointed to the employee.

II TAX PLANNING FOR AND THROUGH CHARITIES – Robert Venables QC

- **What is a Charity?** See the new definition in The Charities Act 2006.

- **Tax Advantages of UK Charities** – General exemption from Direct Taxation; Income Tax, Corporation Tax, capital gains tax, inheritance tax, Stamp Duty, Stamp Duty Land Tax. Very limited exemptions from Indirect Taxation, especially value added tax and customs duties.

- **Varying the Dispositions of the Estate of a Deceased Person while gaining an Income Tax and/or Capital Gains Tax deduction**- see Inheritance Tax Act 1984 s.142 (Alteration of dispositions taking effect on death). See *St Dunstan's v Major (Inspector of Taxes)* [1997] STC SCD 212 involving Gift Aid where donor was held to receive a benefit and the charitable gift was not a "qualifying donation" under FA 1990 s.25. Robert wonders whether the case is rightly decided? Assuming it to be rightly decided, ensure that benefit of inheritance tax saving passes to the charity or to a non-connected person.

- The **non-qualifying expenditure** rules were totally inept. The best thing which could be said in their favour was that the Revenue by and large ignored them! The new rules are even more inept.

  - The *New Substantial Donor Rules*

  - The Statute: Finance Act 2006 has inserted in Income and Corporation Taxes Act 1988 ss. 506A – 506C. They work by treating various payments made by a charity as "non-charitable expenditure". Who is a "Substantial Donor"? – see s.506A(2) and (3) (denial of tax relief for the charity can be *retrospective*).

- **Gifts from Close Companies**

Note there is no relief from NIC contributions. Therefore could be better for wholly-owned company to make a donation than for remuneration/partnership profits to be paid to individual who then makes a gift aid payment to charity. If company pays dividend and recipient then makes a gift aid payment, could be less tax efficient than company making the gift aid payment, especially where company pays corporation tax at a rate of more than 19%.

III TAX PLANNING for FOREIGN DOMICILIARIES – James Kessler QC

- **Progress on the reform of foreign domiciliaries**

The charade continues in *Hansard* 16th October 2006:

> *Jim Cousins*: To ask the Chancellor of the Exchequer what changes have been made to residence and domicile rules relating to taxation as a consequence of the review of such rules in April 2004.
>
> *Dawn Primarolo*: The review is ongoing.

- **Residence of Professional Trustees**

The original form of s.69(2) TCGA applies only until 6th April 2007. This thoroughly sensible provision allows UK professional trustees to act without attempting to tax them. The object is to allow the UK to compete on equal tax terms with foreign trustees. The rule also helped keep administrative expenses down. The reason given for its abolition is that the DTI had advised the rule breached EU restrictions on State Aid. HMRC have refused to disclose the DTI advice. An application to the Information Commissioner under the Freedom of Information Act is pending. But apparently it will take more than a year for the Information Commissioner's Office to assign a case worker to the file.

Moral:

In most cases the new rules will not change trustee residence. The following are the more common cases of change (it is not a complete list):

(1) Trustees relying on the CGT professional trustee rule to secure non-residence will become UK resident (for CGT);

(2) Non-residence trustees with UK branch, agency or permanent establishment will become UK resident for IT and CGT;

(3) Trusts with a UK linked settlor and a minority of UK trustees will become resident for CGT.

In these cases action is essential before 6th April 2007 so it is now becoming urgent.

- **Initial interests of settlor or spouse** IHTA s.80 fictions.

(i) *Avoiding s.80 problems: trusts made after 22/3/2006*

No problems for lifetime trusts (except disabled persons interests) but take care with will trusts which confer an IPDI if the testator is UK domiciled and the spouse is not. A simple solution is to arrange that the trust is discretionary at the outset, i.e. the settlor and spouse do not have an initial interest in possession. A two year discretionary period may be needed. This is easy if the property to be given to the trust is not UK situate. If you go wrong, a s.142 variation may put matters right.

(ii) *Avoiding s.80 problems: trusts made after 22/3/2006*

In cases where existing trusts confer an initial IP on the settlor/spouse, it would be desirable to revoke the IP before the settlor becomes deemed UK domiciled. It does not matter that the settlor/spouse may have an initial recognised IP provided that when it comes to an end (not being followed by another IP for the settlor/spouse) the life tenant is not UK domiciled or deemed domiciled.

- **Postponing s.80 problems**

A partly-excluded property trust should retain a recognised IP for as long as possible. In practice it will often be good planning to create a transitional serial interest ("TSI") to extend this period. The trust falls within the standard IHT trust regime on the later of the times when:

(1) a TSI comes to an end (assuming there is no recognised IP)

(2) the IP of the settlor/spouse comes to an end.

IV TAX PLANNING for SHAREHOLDERS – Amanda Hardy

- **IHT Business Property Relief** was emphasised by Amanda, including analysis of the leading cases, e.g.:

- *Phillips v IRC* [2006] SpC 555

  Shares in a money lending company, PP Investments Limited. 8 other companies established by the deceased. Left shares to widow in 2000, she died in 2001 leaving shares to children. For 10 years PP Investments had done nothing but lend to the 8 other companies which were property dealing and property investment companies.

  Special Commissioner held that PP's business was not one of wholly or mainly making investments and therefore not within s.105(3) and BPR was available. Making a loan was not making an investment, although the purchase of a security was an investment, here the loans were informal and repayable on demand without security and the fact that the loan was to an investment company was irrelevant. An appeal may result.

- *Marquess of Hertford v IRC* [2005] STC (SCD) 177 Historic house, 70% of which used in house opening business, 30% as private home was a single asset used in the business and therefore the whole value included under s.110. No appeal.

- **Deferred Shares Strategy** (also referred to in Robert's talk).

- A bonus issue of deferred shares is made to the existing ordinary shareholder of the company (or the existing shares are reorganised). This can be effected as a reorganisation with no tax consequences.

- For a fixed period these deferred shares carry no voting rights, dividend rights or rights to receive distributions on a winding up (say 30 years).

- At the end of the period, the shares automatically carry substantial rights (e.g. ranking equally with all other shares).

- The idea is to create a new class of shares which are initially of low value (and an important point in determining value is the length of the fixed period), and can therefore be given at no or little inheritance tax cost, but which then acquire value over a period of time.

- The deferred shares may be given to individuals absolutely or to a discretionary trust (relying on a low value of the share) or be sold at market value.

- Note that while the principle is simple, the detailed implementation is often complex. Accurate share valuations and tailor-made drafting of articles are required.

- These arrangements are of a medium to long term nature.

• **IHT**

- Note the period should be fixed, not that of a life, so that s.171 IHTA 1984 does not apply.

- Note that the ordinary shares should not pass to the deferred shareholder as that may be a disposition by associated operations.

• **The way forward?**

- The Statements (e.g. Shares Valuation Manual 26220 Deferred Shares) envisage deferred shares which, at a specific moment in time, come to rank equally with another class of shares.

- Consider rights selected by a formula which involves a steady reduction in the value of the shares that is arguably not within s.98 IHTA 1984.

V CROSS BORDER ESTATE PLANNING – Dr Timothy Lyons QC

• Timothy explained this subject involved a multi-disciplinary activity affecting a wide range of topics, including: Private international law and matrimonial law/civil partnerships; property law; succession law; taxation/double taxation/ multiple taxation.

• In the area of *taxation*: opportunities for *double* or *multiple charges* arise because of: taxation in the state of: *domicile* of donor/deceased; *residence* of the donor/deceased; *residence* of the legatee/donee; *situs* of the assets in question.

- Treaties avoiding *double taxation* may be helpful but there are relatively few. Unilateral relief may be available. Practitioners must consider to what extent EC law may assist?

- Timothy drew delegates' attention to a number of ECJ cases affecting wealth and inheritance taxes: see in particular:

  Case C-251/98 *Baars* [2000] ECR 1-2787

  Case C-364/01 *Heirs of H Barbier* [2003] ECR 1-15013

  Case C-376/03 *D* 5th July 2005

  Case C-513/03 *van Hilten* 23rd Feb 2006

  Case C-9/02 *De Lasteyrie* [2004] ECR 1-2409

  Case C-470/04 *N* 7th Sept 2006

  Case C-196/04 *Cadbury Schweppes* 12th Sept 2006

- The EC Commission has sent reasoned opinions to Ireland and Poland asking them to end discrimination against foreign charities: 17th Oct 2006. A reasoned Opinion was also sent to the UK: 10th July 2006.

VI WHAT TO DO WITH THE FAMILY HOME? – Richard Vallat

- **Introduction**

For many people, the family home forms a large part of their estate. They would like, therefore, to remove it from their estate whilst remaining in occupation and without (a) creating an immediate IHT liability, (b) losing the benefit of the main residence or PPR relief from CGT, or (c) creating an SDLT charge. Unfortunately, there are a number of tax provisions that make this difficult:

- The gift with reservation of benefit provisions, as amended to counter the *Ingram* scheme (FA 1986 s.102A), the *Eversden* scheme (FA 1986 s.102(5A)), and the termination of an interest in possession (FA 1986 s.102ZA);

- The pre-owned assets rules in FA 2004 Sch 15;

- The fact that SDLT is chargeable on any transfer of land whether or not completed, and that any debt charged on the land and assumed to any extent by the transferee counts as chargeable consideration; and

- The charges on transfers into lifetime trusts (even if the settlor is the life tenant) introduced by FA 2006 Sch 20.

Nonetheless, there are *still several options available*: (It is assumed in what follows that the "family home" means the main residence which is occupied all year and qualifies for PPR relief).

(1) *Do nothing*

(2) *Gift to spouse or civil partner*

(3) *Sale to spouse or civil partner*

(4) *Transfer to joint occupier* – see FA 1986 s.102B (and not subject to pre-owned asset charge either)

(5) *Sale subject to lease (including equity release)*. If the home is sold for full value but subject to a right to take a lease back, there should be no gift and no Sch 15 charge. The purchaser might be family or third party (i.e. an equity release scheme). Later the vendor could give away proceeds (to someone other than the purchaser).

(6) *Use of debt* – a simple idea is to borrow on the security of the house, invest the proceeds in assets qualifying for APR or BPR relief and, in due course, give away those assets. One problem may be finding a safe investment that qualifies for relief (particularly after the Pre-Budget Report on 6 December?). Another is that if the borrowing is commercial it will of course bear interest.

(7) *Use of the Nil Rate Band* – it is always worth remembering the nil rate band (currently £285,000). A common (and in Richard's view, effective) way to take advantage of this is to leave an amount equal to the nil rate band on discretionary trusts with the balance of the estate left to the surviving spouse (with further provisions relating to relieved and exempt property), ensuring there is no immediate charge.

(8) *Use of BPR* – one use of BPR is as above. Alternatively, it may be that the family home itself be used in a trade. For example: the family farmhouse; bed and breakfast (a small scale B&B will often fall foul of

s.112(6) – asset used mainly for personal benefit – but a larger scale more commercial operation might well qualify); or historic houses.

- **What to do with existing schemes caught by FA 2004 Sch 15 – (pre-owned asset charge)**

(i) Pay the tax

(ii) Pay the *rent*

(iii) *Move out*

(iv) *Elect* for *gift with reservation* treatment

(v) *Avoiding the structure* – see *Wolff v Wolff* [2004] STI 2068

(vi) *Unwind the structure*

VII WILLS and DEEDS OF VARIATION after FA 2006 – Rory Mullan

- **Becoming beneficially entitled to the Interest in Possession on the death of the testator**

Although a pre-existing settlement may be drafted such that the beneficiary is to become entitled only to an interest in possession on the death of a testator, a question arises as to whether Condition 2 of s.49A IHTA 1984 will be satisfied where settled property is added to the trust fund of a settlement in which a person already enjoys an interest in possession.

This is another instance of the ambiguity which arises from a failure to distinguish between (i) an interest in possession and (ii) the property in which that interest subsists. If one takes what might be considered the sensible view, that the addition of property creates a new "interest" then Condition 2 will be satisfied. If, however, one takes the view that the interest derives from the trust instrument, and that the addition of settled property, while increasing the value of that interest, does not create anything new, it must follow that the person became beneficially entitled to the interest in possession before the death of the testator with the consequence that Condition 2 is not satisfied.

Once again this illustrates the peril in attempting to create an immediate post death interest in possession through a pre-existing settlement.

- **Deeds of Variation for persons who died before 22nd March 2006**

Although the changes introduced in Sch 20 FA 2006 substantially reduce the circumstances in which a person can make or is deemed to make a potentially exempt transfer after 22nd March 2006, property can still be transferred into settlement, or transfers of value arranged under the "old" inheritance tax rules in relation to property which formed part of the estate of a deceased person who died within the last 2 years *but* before 22nd March 2006.

- **Post Death Arrangements**

Given that the immediate post death interest, the trust for the bereaved minor and the age 18 to 25 trust must be "effected by will" and "established under … will", a question arises as to the extent that arrangements can be made to alter the effect of a Will after death, so that such trusts can be created – see s.142. The extent to which this also deems the variation to have been effected by will, or trusts to have been established by will may be debatable. There would, however, seem to be a reasonable argument that this is an inevitable consequence of the deeming.

At the very least, any deed of variation should be expressed to take effect as if the Will had provided for the new dispositions. Where the Will itself creates a settlement in respect of which new trusts are appointed, it is noted that s.144 IHTA 1984 expressly takes effect as if the variation had been provided for in the Will.

- If the **nil rate band trust created an interest in possession trust** for the benefit of the surviving spouse which fell outside the surviving spouse's estate (i.e. as a consequence of FA 2006 Sch 20), then the executors could retain the benefit of the deceased's nil rate band by simply appropriating a share in the family home to the trustees of that settlement. The trustee could properly allow the surviving spouse to reside in that property, thereby ensuring a tax saving while avoiding the need to enter into a complicated and artificial arrangement.

  Nil rate band discretionary trusts are likely to continue to be necessary given the width of the definition of the immediate post-death interest in s.49A IHTA 1984. While there are circumstances where it might be argued that an interest in possession created by Will is not an immediate post-death interest, it is likely to be preferable to avoid such arguments. Further, given the width of s.144 IHTA 1984 and its mandatory application, it is likely to be the case that a two year delay is necessary before any non-favoured interest in possession can be created in respect of the nil rate band trust.