The Personal Tax Planning Review

INHERITANCE TAX PLANNING FOR THE FAMILY HOME[1]

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1 Peculiar Difficulties

1.1 The King Lear Factor

In general, the advice should be to deal with the family home, if at all, only as a last resort after all other lifetime gifts have been made. Firstly, one should consider the security of the donor, particularly his psychological security, in knowing that there is at least one place he can still call his own. A strategy under which the donor continues to live in his home as of right is preferable to one where he is dependent on the goodwill of his donee ... or the donee's heirs ... or the donee's divorced spouse ... or the donee's creditors or trustee in bankruptcy.[3] The ideal strategy is where the donor's right is to occupy his home throughout his life.

1.2 Gifts with Reservation of Benefit Provisions

Secondly, there are technical difficulties confronting any lifetime inheritance tax planning which were greatly exacerbated by the gifts with reservation of benefit

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1 This article is a condensed version of part of *The Family Home* of which my co-authors are Richard Vallat and James Henderson, recently published by Key Haven.

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3 The client who insists on trusting his donee should be invited to attend a performance of *King Lear*.

provisions, and which have been made more complex by Finance Act 1999. The more effective arrangements usually involve the donor being locked into his present residence for the rest of his life or at least his not being able to extricate himself without the consent of the donee. Even then, there are possible income tax charges.

1.3 Capital Gains Tax Downsides

Thirdly, most arrangements which are effective for inheritance tax purposes are likely to have a capital gains tax "downside". The actual gift itself is unlikely to give rise to a charge to capital gains tax, notwithstanding that after Finance Act 1989 no hold-over relief on gifts is likely to be available, as any chargeable gain will be covered by the principal residence exemption. The difficulty is that any rise in the value of the asset gifted between the date of the gift and the date of the death of the donor will not normally benefit from that exemption. [4] This is rather less of a problem if the donor has a second home which he can, after the gift, elect to be his principal residence for capital gains tax purposes.

An even more serious problem is that a capital gain in the hands of the donee may be manufactured out of thin air and that, given the Finance Act 1989 restrictions on hold-over relief on gifts, it may be impossible to avoid this gain being taxable in due course. With the raising of the top rate of capital gains tax to 40% and the reduction of the top rate of inheritance tax to 40% by Finance Act 1988, it is quite possible that in the case of small estates inheritance tax planning may be counter-productive. An appraisal should be made in each case to determine whether the anticipated *net* saving is worth the cost of implementing the arrangements and the consequent loss of flexibility.

This exercise has become even more difficult since the introduction of taper relief from capital gains tax. The family home will in all but the exceptional case not qualify as a business asset for this purpose. Still, after ten years of ownership by the donee, 40% taper relief should be available, thereby in effect reducing the top rate of capital gains tax to 24%.

For those who like sophisticated tax planning, there is a method, involving the use of a trust, which appears to me to be efficacious, whereby the rise in value of the home during the life of the donor can continue to qualify for principal residence relief, just as if it had not been gifted, without any loss of the inheritance tax advantages.

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[4] It could do so if the donee resides in the property as his main residence.

Another possible way of dealing with capital gains tax is to use a strategy which does not involve a disposal of the home (or any interest therein) by a lifetime gift but which relies on indebtedness to reduce the value of the donor's estate.

1.4 Income Tax Problems

Fourthly, income tax charges may arguably be created out of nowhere in an attempt to avoid the gifts with reservation of benefit provisions. Any transaction involving the sale of a lease which has a life expectancy of less than fifty years may well involve part of the price being taxed as income under Taxes Act 1988, Part II. Any lease for a full rent will involve an income tax liability on the rent which, in the case of the tenant's home, will not be matched by any corresponding deduction.

2 Avoidance of Gift

2.1 Sale of Existing Home

If the home can cease to form part of the taxpayer's estate without any gift being made, then the gifts with reservation of benefit provisions should not apply.

The home can be sold by the "donor" to the "donee" (being an individual) for full market value. The "donee" could then, if he thought fit, allow the donor to live there free of charge.

If the donee cannot pay the price in cash, could it be left outstanding? If so, the donor could engage in value-freezing. In principle, it could, provided it was repayable on demand.[5] If it was intended that the loan should remain outstanding long term, it would be important to ensure that the "donee" was good for the purchase price and interest, if demanded, and that the arrangement could not be characterised as a sham.

If the donor failed to call in the loan or to stipulate that interest be paid, he would not thereby make a transfer of value, assuming the donee to be still good for the amount owed. Similarly, the "donee" would not make a transfer of value simply by allowing the "donor" to occupy the property.

Stamp conveyance on sale duty could be a problem, unless, possibly, the matter

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[5] If the loan were repayable only in future, then the "donee" might not have given full consideration, particularly if it bore less than a market rate of interest in the meantime.

were allowed to rest in contract only.[6]

Capital gains tax is, as often, the most serious problem. There would not be any tax on the sale if the home had at all material times been the "donor's" principal private residence. Unless the "donee" were also to occupy the home as his principal private residence, there would be no exemption in respect of the gain accruing during that period of occupation of the "donor" which followed the sale. This would be a problem only if the "donee" intended to sell the property during his life.

One solution would be for the donee, as an independent and unilateral act, independent of the sale, to create a settlement under which the donor had a life interest. That would involve the "donee" making a potentially exempt transfer, but that should not be a problem if he survived the gift by seven years.[7] Matters could be arranged so that on the death of the "donor", the donee took an interest in possession under the settlement. In the author's view, there would then be a tax-free uplift in the capital gains tax base cost of the trustees yet no inheritance tax payable on the "donor's" death. See Inheritance Tax Act, section 53(3) and Taxation of Chargeable Gains Act 1992, section 73.

It would be crucial that the "donee" was the only settlor of the settlement; and in particular that the "donor" was not: see Inheritance Tax Act, section 44.

2.2 Sale of Reversion on Lease

2.2.1 No Gift with Reservation of Benefit

The sale of the reversion on a retained lease for a proper price by the "donor" to the "donee" will not amount to a gift at all and therefore there is no possibility of any of the gifts with reservation of benefit provisions being brought into play.

2.2.2 *Furniss v Dawson* and Associated Operations

Care must be taken if the consideration for the reversion is to be provided by the "donee" out of resources which have been provided by the donor. If the donor made a gift to the donee before there was any question of the reversion being purchased, it is difficult to see how *Furniss v Dawson* could possibly apply. It is not

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6 And the house was worth less than £10,000,000.

7 His reversionary interest would not constitute excluded property: see Inheritance Tax Act, section 48(1)(b).

inconceivable that the Revenue might claim that no matter how great the gap between the gift by the "donor" and the purchase of the reversion that the donor had made a transfer of value of the reversion by associated operations.[8] Such a claim would in the author's view be misconceived if the gift were not made for the purpose of facilitating the reversion to be purchased. Even if it were, it is highly questionable whether the invocation of associated operations would allow the Revenue to collect one penny more tax.[9] In particular, the "donor" would not in the author's view have made a gift by associated operations for the purposes of the gifts with reservation of benefit rules, unless perhaps the "don ee" were legally obliged to return the "gift" in payment of the purchase price.

2.2.3 The Proper Price

One difficulty which arises in the context of the family home is in fixing the proper price, especially as such transactions are not commonly entered into. If the sum of the values of the lease and the reversion are equal to the value of the unencumbered freehold, there is no problem. The price which the "donee" will pay will be the value of the reversion in his hands which will happily make good the potential diminution in the "donor's" estate caused through the loss of the reversion.

In practice, the situation will not be so easy. There will almost certainly be a "divorce value" which will be lost as a result of the division of the unencumbered freehold into reversion and the retained lease. The position is complicated if the "donor" has, or might in future have, statutory protection. The value of each interest is made more speculative if the duration of the lease is fixed by reference to the duration of the "donor's" life.[10]

Suppose the "donor" sells the reversion at a price equal to its value to the "donee". That will involve a diminution in the "donor's" estate for inheritance tax purposes. Whether or not that would involve a transfer of value would depend upon whether the transactions were intended to confer a gratuitous benefit on the "donee" or on any other person.

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8 For some truly outlandish submissions which have been made in its behalf in relation to associated operations and which have never been adjudicated on, see the decision of the Special Commissioners in *IRC v Brandenburg* [1982] STC 555.

9 See my article "Gifts by Associated Operations" in *The Personal Tax Planning Review* Volume 5 1996/7 Issue 1, at 11. See also *Rysaffe Trustee Co (CI) Ltd v IRC* [2002] EWHC 1114 (ch) [2002] STC 872 for the limited effect of the associated operations provisions.

10 This is not a recommended course of action, for the reasons given at 3.6.

Although it is important to know whether the "donor" has made a transfer of value, it is much more important to know whether he has made a "gift" within the meaning of Finance Act 1986, section 102(1).[11] The better view is that if the "donor" has no gratuitous intent, he will not make a "gift" any more than he will make a transfer of value. If, however, the sale is part of overall arrangements which are intended to benefit the "donor's" heirs by reducing the inheritance tax charge on his estate, then the contrary is not unarguable.

Would it therefore be wiser in all cases for the "donee" to pay the "donor" an inflated value for the reversion so as to ensure that there was no diminution in the estate of the "donor" as a result of the transactions? If the lease back is not a lease for life within the meaning of Inheritance Tax Act 1984, section 43(3), this would clearly be the safer course. A lease for life is not recommended.[12] Although the "donee's" estate would diminish in value, he would arguably not have made a transfer of value, as his motive would have been not to benefit the "donor" but to benefit himself by reducing the inheritance tax burden upon the "donor's" estate of which he confidently expects to be a beneficiary. Even if the "donee" did make a transfer of value, it should qualify as a potentially exempt transfer and thus, provided the "donee" lived for seven years, have no adverse inheritance tax effect.

2.3 Sale of Reversionary Lease

The sale of a reversionary lease will prevent any of the gifts with reservation of benefit provisions from applying.

The capital gains tax consequences will broadly be the same as on a gift.

Provided the reversionary lease is long enough, which should present no problem, the lease premium provisions will not bite.

The observations in section 2.2 on *Furniss v Dawson* and the proper price apply, *mutatis mutandis*, in this context too.

2.4 Acquisition of New Home

Where the "donor" wishes to acquire a new home, one might consider the "donor" and the "donee" together purchasing different interests in it. If the unencumbered

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11 Or section 102A(1) or section 102B(1).

12 See the second edition of my *Inheritance Tax Planning* at 8.9.4A.

freehold were for sale, the "donor" could purchase a twenty-one year lease and the "donee" the reversion. Or the "donee" could purchase a reversionary lease and the "donor" would purchase the freehold subject thereto.

While the vendor would of course receive the same price as if the unencumbered freehold were being sold to one person, his tax position would have to be considered. He might be advised that, on account of the Schedule A lease premium provisions, he should undertake the sale in one form but not another.

The stamp duty position would have to be considered. It could be a little worse than in the case of a straight purchase. It could also be rather better, depending on the figures.

The long-term capital gains tax disadvantages are the same as in any scheme of this type.

One potential disadvantage of lease carve-outs, even before Finance Act 1999 was enacted, was that if the " donor" wished to sell the retained lease, there was an argument that the Schedule A lease premium provisions would bite so as to impose a charge to income tax. In the context of a purchased lease, that is not a problem, provided it was acquired on arm's length terms.

What is the position if the "donor" lends the "donee" the cash with which to buy his interest? Provided that there is no element of gift, in the author's view the strategy should still be effective. Care should, of course, be taken as to the terms of the loan. The creditworthiness of the "donee" is important, but less so than in the case of the sale to him on credit by the "donor" of the unencumbered freehold. For he has acquired an appreciating asset and he is not expecting to allow the "donor" to occupy the property gratuitously.

What if the "donor" were to gift the purchase price to the "donee"? The gifts with reservation of benefit provisions substituted property rules do not apply to non-settled cash: Finance Act 1986, Schedule 20, paragraph 2(2)(b). This applies in relation to sections 102A and 102B as it does in relation to section 102: section 102C(4).

2.5 Purchase by Existing Trust

A new or existing home could be sold to an existing suitably worded trust of which the "donor" is not (and does not by the exercise become) a settlor. The "donor" would need to be entitled for an interest in possession and the gifts over would be such as the "donor" would approve of. For example, the trust may have been created by the donor's parent or late spouse for the donor for life, remainder to his children. The trustees would divide the freehold up into a wasting interest held on the interest in possession trusts and an appreciating interest held on trust for those entitled in remainder. As there would be no gift by the "donor", none of the gifts with reservation of benefit provisions would apply. In the author's view, the arrangement would also be advantageous in capital gains tax terms in that principal residence exemption would be available (subject to the usual conditions being satisfied) not just as regards the wasting asset but as regards the unencumbered freehold.

3 Gift of Reversion Subject to Lease

3.1 Introduction

The use of a lease to be retained by the donor [13] offered a good solution to the problem, prior to the insertion by Finance Act 1999 of sections 102A to 102C in Finance Act 1986. It can be still be used, provided the application of those sections can be excluded.

The strategy was unsuccessfully contested by the Revenue in *Lady Ingram,*[14] in which I appeared as Leading Counsel for the Executors. That defeat gave rise to the inept insertion by Finance Act 1999 of sections 102A, 102B and 102C ("the 1999 Code) into Finance Act 1986.

If the arrangements are properly constructed, and the 1999 Code can be circumvented, the home can in my view be gifted to the next generation with only a modest transfer of value and no gift with reservation of benefit. The donor can be given relative security of tenure. The potential capital gains tax disadvantages are, however, and have always been, considerable and were not diminished by the restriction on holdover relief introduced by Finance Act 1989. There are also income tax traps to be avoided. Moreover, arrangements of this type can be particularly troublesome if the donor wishes to change homes.

In the following discussion, it is assumed that the donor owns the freehold. Where his interest is only leasehold, then references to the freehold should be construed as

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13 The jargon for this strategy is a "lease carve-out scheme".

14 *Ingram and another (executors of the estate of Lady Ingram, deceased) v Inland Revenue Commissioners* [2000] STC 37.

references to the leasehold and references to the lease as references to the sublease to be carved out of his lease. Where the donor's interest is leasehold, care must of course be taken to ensure that the implementation of arrangements does not entail a breach of covenant and thus expose the leasehold to forfeiture.

3.2 Mechanics

3.2.1 The Basic Scheme

One of the best ways of avoiding the gifts with reservation of benefit provisions *in limine* is to perform a "shearing" exercise and to gift only the property shorn of certain rights.

On Day One, the lease should be created. This will involve the use of a trustee. The duration of the lease is discussed at 3.6 and 3.7. While the lease may contain terms onerous to the tenant, it should contain no terms onerous to the landlord. For the assumption of the liability of those terms by the donee on the assignment of the reversion to him might arguably in the circumstances amount to collateral consideration given by him and thus to a gift with reservation of benefit.[15] As well as avoiding express covenants, one should also exclude implied covenants, unless one can be sure that their existence does not prevent the property being enjoyed "virtually" to the exclusion of the donor and of any benefit to him by contract or otherwise.

On Day Two, the reversion is transferred to the donee by way of gift using the appropriate conveyancing machinery. Again, care must be taken to avoid any express or implied covenants given by the donee on the assignment which might constitute collateral consideration.

The Revenue attacked the validity of such a lease in *Lady Ingram*. The House of Lords held that the lease was valid.

3.2.2 Variants on Basic Scheme

Variants were sometimes adopted to try to circumvent a Revenue attack on the validity of the lease similar to that which was being made in *Lady Ingram*, where the basic scheme had been adopted. One variant was for the donor on Day One to grant a lease to himself and another as joint tenants in equity in trust for themselves as tenants in common in the proportions 99% to the donor and 1% to the other joint

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15 See *Re Nicholls* [1975] 1 WLR 534 and *Lady Ingram* [1999] STC 47 per Lord Hoffmann at page 45 a-b.

tenant.

Another variant was for the lease to be granted to the spouse of the donor for her own use and benefit absolutely. This obviously involved the donor placing considerable trust and confidence in his spouse. If the donor predeceased his spouse, the lease itself would not be caught by the gifts with reservation of benefit provisions on account of Finance Act 1986, section 102(5)(a).[16]

While these variants did no harm, since the decision of the House of Lords in *Lady Ingram*, we now know that they were not necessary.

3.3 Rent

Normally, it will be desirable for no rent to be payable under the lease. It might be appropriate in some cases to provide that the rent shall be a certain minimum amount if, as a result, the tenant will thereby enjoy statutory security of tenure on the expiration of the common law lease.

3.4 Inheritance Tax Consequences

The House of Lords upheld the view, expressed in my *Inheritance Tax Planning*, that the above arrangements constitute a gift of the freehold reversion free of any reservation of benefit and a retention of the leasehold interest in possession.[17] The donor retains a benefit, but it does not trench in any way upon the possession and enjoyment by the donee of the property gifted or prevent it from being enjoyed to the entire exclusion of the donor and of any benefit to him by contract or otherwise. The donor's only benefit is from property he has not gifted. This is a classic shearing exercise, indistinguishable from *Munro*.[18]

There will, of course, be a transfer of value made by the donor, but that will be restricted to the diminution in value of his estate as a result of gifting the reversion and keeping the lease. While the measure of the value transferred falls within the province of a qualified valuer, it should be borne in mind that in all probability it will be greater than the value of the interest gifted, as the market for residential accommodation places a substantial premium on vacant possession and there may

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16 See *The Family Home* 5.2.6.1.

17 See my article " *Carbolic Smoke Ball Protects Against Influenza" or Lady Ingram in the House of Lords*, in *The Personal Tax Planning Review* Volume 6 Issue 1 page 177.

18 See *The Family Home* 5.4.2.

well be some "marriage value" between the lease and the reversion which will have been lost by the separation. One might call it a "divorce" loss. This transfer of value will fall to be taxed like any other transfer of value made *inter vivos*. In particular, there is no reason why it should not qualify as a potentially exempt transfer, provided the normal conditions are satisfied.

3.5 Capital Gains Tax Consequences

The donor will make a part disposal of the home. Whether or not this will be chargeable will depend upon whether the principal residence exemption is in point. If it is, the main capital gains tax drawbacks will be those mentioned in 1, namely the loss of the capital gains tax exemption on the rise in value of the house from the date of the gift until the time the donor ceases to occupy it and the low base cost of the donee for any subsequent disposal by him.

If the principal residence exemption is not available, there will normally be no possibility of hold-over relief on gifts.[19] One *advantage* of the arrangement in such cases as compared with an absolute gift is that the chargeable gain will be reduced. A further *disadvantage* is that if the donor comes to dispose of the lease *inter vivos*, the remaining part of his base cost (not taken into account in calculating the gain on the original gift) will have been eroded, as the retained lease is a wasting asset. This disadvantage can be avoided by gifting a reversionary lease and retaining the freehold.[20] Alternatively, both interests could be held by the trustees of the same settlement (on distinct trusts).

3.6 Lease for Life

3.6.1 General Inadvisability

The duration of the lease is one of the more difficult questions to determine. Ideally it should last for the life of the donor or, if the donor is married, for the life of the survivor of himself and his spouse, and not much more. This presents so many fiscal problems, however, that the author's general advice is that leases for life or lives be eschewed.

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19 There are sophisticated strategies which survive the attack on *Melville v Inland Revenue Commissioners* [2001] EWCA Civ 1247 [2001] STC 1271 by Finance Act 2000, section 119. See 3.3.7 and 12.3.4.2.

20 See 4.4.

3.6.2 Conveyancing

Since 1926 it has no longer been possible to create a lease for life of real property in England and Wales without creating a settlement.[21] The conveyancing problem can be overcome by having a long lease determinable by reference to a death. At least a token rent should be charged.[22]

3.6.3 The Inheritance Tax Settlement Provisions

There remains an important inheritance tax problem in that Inheritance Tax Act 1984, section 43(3) provides that any lease for life or lives is to be treated as though it were a settlement and as if the settled property were not merely the leasehold but included the interest reversionary on the lease. The provision catches not only leases for life in the strict sense but other leases which have similar economic consequences, for example a lease for a period ascertainable only by reference to a death or which is terminable on, or at a date ascertainable only by reference to, a death and for this purpose where a lease not granted at a rack rent is at any time to become a lease at an increased rent it is to be treated as terminable at that time.

Now it is undoubtedly possible to create a lease which will be deprived of substantially the whole of its value on the death of the tenant without creating a lease for life within the meaning of section 43(3). The difficulty is that such a device could so easily be circumvented by a change in the law which would, in effect, be retrospective. Leases for life were commonly used in estate planning in the days of estate duty. When capital transfer tax was introduced, arrangements which had already been implemented were rendered useless, or worse than useless, unless the lessee had died in the meantime!

If one is caught by section 43(3), one will have the worst of both worlds as there is no comparable provision for capital gains tax purposes, so that there will be no tax-free uplift in the capital gains tax base cost of the lease and reversion on the death of the tenant.

3.6.4 Leases for Consideration

The provision does not apply to the extent to which full consideration was given for the lease. Suppose, however, the donor transfers the home to his "donee" for full

21 See Law of Property Act 1925, section 205(1)(xxvii).

22 See Law of Property Act 1925, section 149(6).

value consisting partly in consideration of cash and partly in consideration of the donee undertaking to grant the donor a lease for life. Can it be said that the lease has been granted for full consideration in money or money's worth? The Revenue formerly took the view that it could: see SP E10 of 7th December 1977. That Statement of Practice was withdrawn as "obsolete" in 1994.[23]

Extreme scepticism had been expressed of the Revenue's view, particularly by me in my *Inheritance Tax Planning*. For it seemed to be based on the erroneous *dicta* in *Nicholls* and the main objection to it was that it proved too much. For even a conveyance of a freehold to a donee on terms that a lease at no rent determinable on the death of the donor was to be granted back to him would involve the lease being granted for full consideration. The reality of the situation is that the freeholder has retained part of his interest and sold or gifted the rest and that the lease has not been granted for full consideration. The discovery in 1994 that the concession had become "obsolete" was a fortunate one, given the view which Ferris J was about to express on *Nicholls* in *Lady Ingram*.

Now that the House of Lords has, in *Lady Ingram,* disapproved of the *dicta* in *Nicholls*, it would be foolhardy for a taxpayer to rely on the argument that full consideration had been given in such a situation.

3.7 Lease for a Fixed Term

A lease for a fixed term will usually avoid the settlement provisions. The difficulty lies in fixing the correct duration of the lease. If it is too short, then *prima facie* the donor will lose security of tenure on its expiration. The problem arises on the expiry of the lease during the lifetime of the donor and before he is ready to quit the home. Clearly, if the freeholder simply allows the donor to remain as a gratuitous licensee, the original gift will thereby become subject to a reservation of benefit unless the dependent relative change of circumstances exemption conferred by Finance Act 1986, Schedule 20, paragraph 6(1)(b) can be relied upon. By its very nature, reliance on this exemption cannot be built into the original planning.

Another possibility is for the donee to grant the donor a new lease of the home, say, a periodic tenancy for full consideration in money or money's worth to take effect no later than the expiry of the original lease back. The exemption contained in

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23 For a fuller expression of my views on Statement of Practice E10, see my *Inheritance Tax Planning* Second Edition at 8.9.3 to 8.9.4.

Finance Act 1986, Schedule 20, paragraph 6(1)(a) could then be relied upon.[24] That provision is not without its difficulties. It may have income tax drawbacks which, either singly or in conjunction with the capital gains tax disadvantages, may outweigh the inheritance tax benefits.

Under estate duty it was a solution for the lease reserved to be for a fixed term and thereafter from month to month determinable by short notice given by either party. If on the expiry of the fixed term the donee, out of love and affection for the donor, failed to serve notice during the remainder of the donor's life, there was no benefit by associated operations.[25] Inheritance Tax Act 1984, section 268, unlike the estate duty legislation, *does* define "associated operations" to include omissions. While arguments can be mounted that such a strategy[26] is still viable, it is not recommended.

If the lease is made too long, then on the donor's death there will in all probability be comprised in his estate the "fag-end" of the lease, which could have a considerable value. A lease at less than a rack rental only begins to fall considerably in value shortly before expiry.

It was formerly possible to create a *de facto* lease for life without creating a lease for life for inheritance tax purposes by the donor taking a lease for a period equal to his life expectancy, as determined actuarially, and relying upon his obtaining statutory rights of protection should he still be alive when the lease expired. It is thought unlikely that any statutory tenancy which arose on the termination of a lease which did not itself constitute a benefit reserved would itself be held to bring the gifts with reservation of benefit provisions into play. The difficulty is that modern statutes have greatly curtailed statutory security of tenure in the case of new leases. Such a strategy may therefore be no longer possible.

3.8 Devise of Lease

It is perhaps advisable for the donor to will what is left of the lease on his death to a person other than the reversioner. If there is a shortage of eligible beneficiaries,

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24 Sections 102A and 102B also have provisions dealing with benefits conferred on the donor for full consideration. They need to be considered on a case by case basis. See *The Family Home* 5.11.

25 See *Nicholls v IRC* [1973] STC 497, Walton J, approved by the Court of Appeal on this point at [1974] STC 230.

26 See the second edition of my *Inheritance Tax Planning* at 8.2.2.

a suitably worded trust could be usefully employed. If the donor is survived by his widow, an absolute gift to her would be ideal.

If the fag-end were gifted to the reversioner, it might be argued that the donor had made a disposition of the unencumbered freehold by associated operations. This gift would be deemed to be made on the donor's death. Although credit would be given for the value transferred by any earlier chargeable transfer of value, for example on the gift of the encumbered reversion, the bulk of the value of the property would in the Revenue's view then be brought into charge and at the full death rates. While there are good arguments for refuting this view, it is one which the Revenue can confidently be expected to adhere to with some tenacity. Where the reversion is sold rather than gifted, the chances of the Revenue succeeding on the argument are considerably reduced.[27]

3.9 Finance Act 1986 Sections 102A, 102B and 102C[28]

3.9.1 Finance Act 1986 Section 102A

Finance Act 1986, section 102A can apply where an individual disposes of an interest in land by way of gift on or after 9th March 1999 and the donor or his spouse subsequently enjoys a significant right or interest, or is party to a significant arrangement, in relation to the land. The effect of it applying is to make the gifted interest property subject to a reservation.

A right, interest or arrangement in relation to land is "significant" if (and only if) it entitles or enables the donor to occupy all or part of the land, or to enjoy some right in relation to all or part of the land, otherwise than for full consideration in money or money's worth.

Hence, a lease carve-out may no longer be effective in avoiding the gifts with reservation of benefit provisions.

If the donor acquired his interest in the land for full consideration, he would appear to be saved by the final words "otherwise than for full consideration in money or money's worth".[29]

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27 For an argument that the value transferred would be nil, see my article "Gifts by Associated Operations" in *The Personal Tax Planning Review* Volume 5 1996/7 at 11.

28 See *The Family Home* 5.11.

29 See *The Family Home* 5.11.4.3.

A right or interest is not "significant" if it was granted or acquired before the period of seven years ending with the date of the gift.[30] Hence, if the lease is first granted to the nominee for the donor and the donor gifts the freehold only seven years later, section 102 will not bite. The position where it is the freehold out of which the lease has been granted which has been acquired more than seven years earlier is more problematic. See *The Family Home* 5.11.4.6

Care must be taken that section 102B does not operate. If it does, it has its own defences which are not all the same as those applicable to section 102A. See 3.9.2.

3.9.2 Finance Act 1986 Section 102B

Where section 102B "applies", it ousts the application of section 102A: section 102C(6). It "applies" where "an individual disposes, by way of gift on or after 9th March 1999, of an undivided share of an interest in land". Except when "subsection (3) or (4) below applies", it causes the share to be property subject to a reservation.

In my view, section 102B applies even where section 102B(3) or (4) applies. It simply has no operation in such cases. See *The Family Home* 5.11.6.

Suppose a classic lease carve-out is undertaken but that only a 95% undivided share in the freehold is gifted. If the donor has bought the freehold, can it be said that the donor "occupies the land to the exclusion of the donee for full consideration in money or money's worth"?[31]

If the donor and the donee occupy the land and the donor does not receive any benefit, other than a negligible one, which is provided by or at the expense of the donee for some reason connected with the gift, then section 102B(4) will be in point.[32] In the lease carve-out situation, the donee would not be occupying by virtue of the interest gifted, but that does not appear to be relevant.

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30 Section 102A(5).

31 See *The Family Home* 5.11.5.4.

32 See *The Family Home* 5.11.5.5.

4 Gift of Reversionary Lease

4.1 The Strategy

The donor should grant to the donee a long lease of the property it is desired to gift on highly beneficial terms. The lease would be reversionary, however, that is, the term demised by the lease would not begin until some future date. In order for the lease to take effect at law, the date could not be more than 21 years after the date of the grant, if at a rent or granted in consideration of a fine: Law of Property Act 1925, section 149(3).[33] Until the lease takes effect in possession, the donor will continue to have the right to occupy the land by virtue of his freehold. Thus there will be an archetypal "shearing" exercise.

In my opinion, this is a very clever strategy, the cleverness and effectiveness of which is by no means diminished by its comparative simplicity. The major problem is that one must define at the outset the period during which the donor will be entitled to retain possession. This can be worse than in the case of a lease for a fixed term retained by the donor on a gift of the freehold.[34]

4.2 Premature Death of Donor

If the donor does not live long enough, then the drawbacks are *prima facie* the same. There will be retained in his estate a freehold which will have some value depending upon the time which will elapse before the lease falls into possession. It is perhaps easier in the case of a retained lease to help devalue the retained asset by imposing onerous covenants on the lessee. It is rather more difficult to impose corresponding obligations on the donor/freeholder before the term of the lease has begun to run.

4.3 Longevity of Donor

Where a lease has been reserved, then it is possible that when the term expires the donor/lessee will still be entitled to retain possession by virtue of tenant-protecting legislation. In the case of a retained freehold, however, there will be no such possibility. The donor/freeholder must therefore accept that he will have to give up possession or, alternatively, enter into an entirely independent bargain with the lessee to take back an occupational sublease which will be prevented from bringing the gifts with reservation of benefit provisions into play by Finance Act 1986,

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33 The position if it is not at a rent or in consideration of a fine is more debatable. See also 4.3.

34 See 4.3.

Schedule 20, paragraph 6(1)(a).[35]

In the case where the donor retains a lease and gifts a freehold, the possibility was discussed of the retained lease being a lease for life. In the context of a gifted reversionary lease and a retained freehold, this is *prima facie* not possible.[36] Nevertheless, there would appear to be no reason why one of the advantages of a lease for life should not be obtained, at least in part, namely the elimination of virtually any value in the estate of the donor on his death so far as is attributable to the interest retained. The lease can, it seems, be granted to take effect on the earlier of the expiration of a given period or the happening of a given event, namely the earlier death of the donor. Certainly, before 1926, a freehold interest could be granted at law subject to a condition precedent. It is only section 1(1)(a) of the Law of Property Act 1925 that now requires such an interest to take effect in possession. By contrast, a leasehold interest can subsist at law provided it is a "term of years absolute": section 1(1)(b), Law of Property Act 1925. The expression "term of years absolute" is defined by section 205(1)(xxvii) to include a term of years "taking effect either in possession or in reversion". The only limitation is that it must not be a term of years "which is not expressed to take effect in possession within twenty-one years after the creation thereof where required by this Act to take effect within that period". Moreover, whatever problems the doctrine of *interesse termini* may have caused, they have been removed by section 149(1) of the Law of Property Act 1925.

If the donor does die before the expiration of the specified period and the lease thereupon takes effect in possession, does one, in determining the value of the freehold immediately before that time, take into account that the right of actual occupation attached to it is to be immediately lost? Inheritance Tax Act 1984, section 171(1) specifies that one does take such change into account provided it falls within subsection (2). Subsection (2) is *prima facie* in point in that the change is a decrease in the value of the property comprised in the estate of the donor, namely the freehold. Moreover, the freehold does not terminate on death nor does any interest pass by survivorship, so that neither of these exclusions from section 171(2) is in point.

In the author's opinion, it cannot be said that the donor has in entering into the lease excluded or restricted by contract the right to dispose of any property. If it

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35 See 5.1.

36 Freeholds for life were abolished at law by the Law of Property Act 1925 and can now subsist only in equity under a settlement.

could, then Inheritance Tax Act 1984, section 163 would come into play.

4.4 Capital Gains Tax

The capital gains tax position is extremely interesting. In the case of a gifted freehold and a retained lease, the freeholder/donee will necessarily have a low capital gains tax base cost. Such part of the base cost of the donor as is referable to the lease retained will be written off over the period of the lease in accordance with the wasting assets rules. To that extent, therefore, part of the original base cost is lost and a potential capital gains tax charge is created out of thin air.

Where, by contrast, a leasehold is gifted and the freehold retained, the position is initially the same. Part only of the base cost will be attributed to the leasehold gifted and the rest will be attributed to the retained freehold. However, provided the exercise is properly structured, the retained freehold will not be a wasting asset for capital gains tax purposes, so the part of the base cost attributable to it will not be written off over the years. In commercial terms, of course, the freehold will be very much of a wasting asset, so that if it is eventually disposed of by the donor he is likely to realise a loss. This is advantageous as compared with a gift of the reversion on a lease.[37]

Of course, in many cases there will be no question of the donor realising an allowable loss. In the first place, the freehold may qualify for the principal residence exemption from capital gains tax. In that case, no loss realised by him would be an allowable loss: Taxation of Chargeable Gains Act 1992, section 16(2). Further, the freehold must in fact be disposed of by the donor *inter vivos*. For Taxation of Chargeable Gains Act 1992, section 62(1) washes allowable losses on death just as much as chargeable gains. The question of an allowable loss is therefore most likely to arise where the property does not benefit from the principal residence exemption and in particular where the donor has survived beyond the time at which the lease takes effect in possession.

Thirdly, the allowable loss must be capable of being set off against some chargeable gain. If it is made on a disposal to a connected person, then it will normally be possible to set it off only against a gain arising on another disposal to the same person: Taxation of Chargeable Gains Act 1992, section 18(2).

One would have to consider very carefully whether the capital gains tax value-shifting provisions might apply. If there is eventually a sublease back to the donor, one will have to make sure that Taxation of Chargeable Gains Act 1992,

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37 See 3.5.

section 29(4) is not accidentally brought into play. A moot point is whether Taxation of Chargeable Gains Act 1992, section 30 could apply on the grounds that the value of the freehold has been "materially reduced" by the grant of the lease within the meaning of Taxation of Chargeable Gains Act 1992, section 30(1)(a). If so, then the conditions specified in section 30(1)(b) will almost certainly be satisfied. The result would be that on an ultimate disposal of the freehold subject to the lease a (higher) notional consideration can be substituted, arguably the market value of the freehold on the basis that the lease did not exist. The author's view is that section 30 does not apply to a reduction caused by a part disposal and does not apply to a gradual drop in value attributable to the very nature of the asset.

4.5 Income Tax

A further advantage of the gifted lease and retained freehold, as compared with the gifted freehold and retained lease, is that if the property is sold before the lease takes effect in possession, there will normally be very little danger of a charge to income tax, whether resulting from Taxes Act 1988, sections 34 to 38 (the lease premium provisions) or section 776 (transactions in land: taxation of capital gains).

4.6 What to do with the Freehold

What should be done with the freehold, now of comparatively little value, once the lease has taken effect in possession? It could be catastrophic to transfer it to the lessee, whether *inter vivos* or on death, even for full consideration. For it might then be argued that the donor/freeholder had made a disposition of the freehold by associated operations, in which case he would make a second transfer of value on the disposal of the freehold on the basis that it was not then subject to the lease, credit being given only for value transferred by the earlier transfer of value on the grant of the lease: Inheritance Tax Act 1984, section 268(1) and (3).[38] If, however, the lease had been granted for full consideration in money or money's worth, then there would be no inheritance tax danger in the freehold being transferred to the donee/lessee more than three years after the grant of the lease: Inheritance Tax Act 1984, section 268(2).

The capital gains tax position is somewhat more complicated if no principal residence relief is available. If the freehold is disposed of less than six years after the grant of the lease, Taxation of Chargeable Gains Act 1992, section 19 (assets

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38 For an argument that the value transferred would be nil, see my article "Gifts by Associated Operations" in *The Personal Tax Planning Review*, Volume 5, 1996/7 Issue 1 at 11.

disposed of by a series of transactions) should be borne in mind.[39]

4.7 Finance Act 1986 Sections 102A, 102B and 102C[40]

4.7.1 Finance Act 1986 Section 102A

This section is potentially a problem.[41] It will not be so if the freehold (or other interest retained by the donor) was granted or acquired before the period of seven years ending with the date of the gift.[42] Unlike the case of the lease carve-out, there is no argument but that the donor's interest after the gift is still the same interest, albeit that it has become subject to an encumbrance.

If the freehold was acquired by the donor for full consideration in money or money's worth, then it is arguable that the section does not apply because the freehold is not an interest which entitles or enables the donor to occupy all or part of the land, or to enjoy some right in relation to all or part of the land, "otherwise than for full consideration in money or money's worth".[43]

4.7.2 Finance Act 1986 Section 102B

Where section 102B "applies", it ousts the application of section 102A: section 102C(6). It "appl ies" where "an individual disposes, by way of gift on or after 9th March 1999, of an undivided share of an interest in land". Except when "subsection (3) or (4) below applies", it causes the share to be property subject to a reservation.

In the author's view, section 102B applies even where section 102B(3) or (4) applies. It simply has no operation in such cases. See *The Family Home* 5.11.6.

Suppose a gift of only a 95% undivided share in a reversionary lease is made. If the donor has bought the freehold, can it be said that the donor "occupies the land to

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39 See C.1.9.

40 See generally *The Family Home* 5.11.

41 For a means of avoiding the problem by selling the reversion on the lease, see 2.2.

42 Section 102A(5).

43 See *The Family Home* 5.11.4.3.

the exclusion of the donee for full consideration in money or money's worth"?[44]

If the donor and the donee occupy the land and the donor does not receive any benefit, other than a negligible one, which is provided by or at the expense of the donee for some reason connected with the gift, then section 102B(4) will be in point.[45] In the reversionary lease situation, the donee would not be occupying by virtue of the interest gifted, but that does not appear to be relevant.

It should be noted that if the gift is one of an undivided share in land, section 102B will *prima facie* apply to the exclusion of section 102A and there is nothing in section 102B corresponding to section 102A(5). Hence, the mere fact that the land was acquired for full consideration more than seven years before the gift will not avail. This is a potential problem where the only interest the donor can dispose of is an undivided share in land.

5 Lease – Rejected Options

5.1 Gift of Freehold followed by Subsequent Lease Back

5.1.1 The Problem

A gift of a freehold followed by a lease back to the donor will normally be fatal. For the home will simply be brought into charge to tax again at its then value on the donor's death.

5.1.2 The Statutory Exemption

It may be tempting to rely upon Finance Act 1986, Schedule 20, paragraph 6(1)(a) which provides that in the case of property which is an interest in land, retention or assumption by the donor of actual occupation of the land is to be disregarded if it is for full consideration in money or money's worth. In the author's opinion, while this provision may avert a disaster for those who might otherwise have fallen into a trap, it is most unlikely to be the basis for the most efficient planning.

Where the full consideration given by the donor consists of a rack rent, one effect of the arrangements will have been to create taxable income out of thin air. On the

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44 See *The Family Home* 5.11.5.4.

45 See *The Family Home* 5.11.5.5.

assumption that the home is situated in the United Kingdom, the income will be taxable under Schedule A. Taxability of the donee will thus in general not depend upon whether he has in fact collected the rent. Nor will the rent usually be deductible in computing the donor's total income for income tax purposes.

Another difficulty, which is only adumbrated here, is the question of what precisely constitutes full consideration. Is it a rack rental or should a premium be paid in addition? That is complicated immensely by tenant-protecting legislation. The taking of a premium may well be illegal even though the market would bear it.

It should be noted that under Schedule 20, paragraph 6(1)(a) it is only in terms of the retention or assumption by the donor of actual occupation of the land which is to be ignored. Ownership of the lease will be an additional benefit. Presumably, in order to give any effect at all to paragraph 6(1)(a), where the donor is in actual occupation by virtue of the lease one must also disregard the reserved benefit consisting of ownership of the lease.

Once the donor is for whatever reason no longer in actual occupation, there is apparently nothing to prevent the lease being taken into account. The home thus becomes property subject to a reservation. Any form of subletting would therefore be fatal.

A disposal of the lease, accompanied by a simultaneous giving up of actual occupation of the land, is slightly more difficult. Unless the lease were surrendered, its continued existence would arguably trench upon the gift. If the donor gifted the lease, then it could probably be said the property was being enjoyed to his entire exclusion and to the exclusion of any benefit to him by contract or otherwise. But suppose he were to sell the lease and retain the proceeds? He is enjoying a benefit and the benefit is referable to a lease which does in fact trench upon the donee's enjoyment of the property.

5.1.3 Transfer of Value by Donee?

A related problem is whether, if the donor were to obtain statutory security of tenure, the donee would make a transfer of value in granting the lease back. It is often the case that no one in their right mind would normally grant such a tenancy to an individual unless there were gratuitous intent. For there would normally be a tremendous diminution in the estate of the landlord as a result of the grant.

5.1.4 Income Tax Charge?

The grant of the lease by the donee for a premium might well create an income tax charge. If the likely duration of the lease were less than fifty years, a part of the premium would be taxable as income. If the lease is for less than one year, then the whole of the premium is taxable as income. If the lease is for more than fifty years, no part of the premium is taxable as income. If the lease is for more than one but less than fifty years, the proportion of the premium which is taxable as income diminishes with the expected duration of the lease.[46] It has been suggested that the lease premium provisions do not apply where the lease is of uncertain duration. In opinion, however, they apply as if the lease were to terminate on the first day at which it appears, at the date of the grant, that there is less than an even chance of it still being in existence: see Taxes Act 1988, section 38.

5.2 Gift and Contemporaneous Lease Back

Suppose the donor gifts the property to the donee subject to an obligation on the donee to grant back a lease to the donor at, say, a peppercorn rent. I stated in various editions of my *Inheritance Tax Planning*: "But for the decision of the Court of Appeal in *Nicholls v IRC*,[47] one might well have thought that as the donee never obtained in equity the unencumbered freehold, there was simply a gift of the reversion over which no benefit was reserved and a retention of the lease. The Court of Appeal, however, established the contrary in *obiter dicta* almost as strong as *ratio",* The House of Lords rejected those *dicta* in *Lady Ingram*.[48] The real problem is now, not *Nicholls,* but Finance Act 1986, sections 102A and 102B.

6 Purchase of Interest from "Donee"

6.1 Purchase of Lease

It may be tempting to ask whether a "donor" should not simply sell his existing home, thereby converting his estate into cash and offering greater flexibility for estate planning. At the same time he would purchase a lease of another property from the "donee". This expedient is available only if the donee already has an available house or the resources with which to acquire one. Where the donee has only limited resources, it might be possible in some cases to effect a joint purchase on the open market from an independent third party. That, however, raises tax

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46 See Taxes Act 1988, sections 34-43.

47 [1975] 1 WLR 534.

48 [1999] STC 37.

problems of its own.

This stratagem has certain rather obvious advantages. Assuming the "donor" gives full consideration to the "donee", he will not make a transfer of value. The lease which is purchased can be one for the life of the "donor" (or of the "donor" and the "donor's" spouse)[49] without any fear of the settlement provisions of the Inheritance Tax Act 1984 being brought into play.[50] A sum of money will thus pass out of the donor's estate at the time the lease is purchased, but as at that point there will be no diminution in the value of his estate he will make no transfer of value. By the time of his death the lease will probably be of little value, especially if it is a lease for life.[51] As the "donor" will never have made a gift, there will not be the slightest question of any reservation of benefit. In short, the whole exercise is a marvellous inheritance tax disappearing trick!

The problem is that the lease would be comparatively short, almost certainly less than twenty-five years. In that case, the grantor of the lease would be exposed to a direct charge to income tax on at least half of the premium! See Taxes Act 1988, section 80. This charge is calculated to detract from the inheritance tax advantages of any such arrangement.

6.2 Purchase of Freehold Subject to Reversionary Lease

A variant, which avoids the lease premium provisions, is for the "donee" to grant a reversionary lease to a nominee for himself and then to sell the encumbered freehold to the "donor".

7 Double Trust Schemes

7.1 The Strategy

A strategy is being marketed, with various variants and permutations, along the following lines.

(1) A United Kingdom resident and domiciled individual ("A") owns a United Kingdom home. A wishes to remain in occupation of the

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49 Strictly speaking, the lease would be determinable after the death of the "donor": see 3.6.1.

50 See 3.6.3.

51 See Inheritance Tax Act 1984, section 171 for valuation provisions.

property.

(2) A has always occupied the property as his main residence such that Taxation of Chargeable Gains Act 1992 ("TCGA 1992") section 222 applies to exempt any capital gain on the disposal of the home.

(3) A creates Trust 1, a flexible life interest trust for A with remainders over to his issue.

(4) The initial capital is cash of, say, £1,000.

(5) The trustees of Trust 1 contract to buy the property from A for a market value consideration.

(6) The contract may be completed by a legal transfer. Even if it is not, there would apparently be a vesting of the full equitable title in the purchasers, so that A became a bare trustee.

(7) In some form or another, credit is given for the purchase price.

(8) A, if he thinks fit, creates Trust 2, the trusts of which will be such that any gift to it would constitute a potentially exempt transfer.

(9) A, if he thinks fit, gifts the benefit of the loan to Trust 2.

Steps (8) and (9) are taken independently of Steps (1) to (7).

7.2 Inheritance Tax

Provided the sale is for a market value consideration, A will make no disposal of the property by way of gift so that Finance Act 1986, sections 102 to 102C will not be in point as regards the sale to Trust 1.

If the sale were for less than a market value consideration, Finance Act 1986, section 102A would *prima facie* apply. If the disposal were of an undivided share in land, section 102B would *prima facie* apply. In either case, it would be for consideration whether any of the relevant exceptions would be in point. [52] The effect of either of the sections applying would be to deem the home to be comprised in the estate of A on his death (assuming the reservation so long continued) without any

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[52] See *The Family Home* 5.11.

deduction for the amount of the loan. If the gifts with reservation of benefit provisions do not apply, all that should be included in his estate is the value of the home reduced by the value of the debt owed by the trustees of Trust 1.

The disposal by A of the benefit of the loan to Trust 2 will be by way of gift. *Prima facie*, there should be no reservation of benefit so that Finance Act 1986, section 102 is not in point. There would be a reservation of benefit if the trustees or their beneficiaries conferred a benefit on A, even by omission, e.g. by failing to call in an interest-free loan repayable on demand.

Finance Act 1986, section 102A will apply if the right to be paid the debt is "an interest in land" for the purposes of section 102A, Finance Act 1986. If, therefore, the debt (as is usual with regard to such arrangements) is protected by a creditor's right of subrogation against the trust fund of Trust 1, the element of subrogation could arguably make the debt an "interest in land". The expression "interest in land" is not defined. *In Re Watts* (1884) 27 Ch.D 318, a debt secured by mortgage on a life interest in a fund including land was held to be an "interest in land" for the purposes of the Mortmain Acts and in *Cooper v Critchley* [1955] Ch. 431, an interest in the proceeds of sale of land were held to be an "interest in land" for the purposes of section 40 of the Law of Property Act 1925. These cases are not on section 102A or on any provision relating to estate taxes. The loan documentation must be extremely carefully drafted to ensure that the debt is purely a personal obligation and the creditor has no proprietary interest in the property.

7.3 Capital Gains Tax and Income Tax

It is crucial to consider the precise terms of the loan. Consider the following possibilities.

(a) No interest is charged. The amount is payable on the death of A. The sum then payable is increased to take account of the delay in payment. (This could be an amount fixed at the start and dependent on current interest rates and A's life expectancy or it could depend on the date of A's death.) When the benefit of the debt is assigned to the trustees of Trust 2, it could be worth only a fraction of the amount they will realise on repayment. Is the gain taxable?

One would have firstly to consider whether it is taxable as a discount under Schedule D, Case III. See *Ditchfield v Sharp*.[53] If not, one would have to consider whether the relevant discounted security provisions contained in Finance Act 1996, Schedule 13 applied. In either case, the gain would be subject to income tax.

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53 (1983) 57 TC 555; [1983] STC 590; [1983] 3 All ER 681.

If there is no income tax charge, what prevents there being a capital gains tax charge? It is not Taxation of Chargeable Gains Act 1992, section 251(1), which does not apply to a gain realised by an assignee from the original creditor. While the sale to Trust 1 could possibly be structured so that the trustees of Trust 2 became the "original ... creditor" of the debt owed by the trustees of Trust 1, that would arguably mean that A had made a disposal by way of gift of the land, thus bringing Finance Act, section 102A or 102B into play. The result would be that the value of the land would be brought into charge to tax on his death without any deduction for the amount of the debt.

(b) No interest is charged – the principal is repayable on the death of A but is not increased to compensate for the delay in payment.

A will make a (partial) gift to Trust 1. Hence, Finance Act 1986, section 102, 102A or 102B will apply unless some exception is in point. If it is not, this scenario is not viable.

When the benefit of the debt is assigned to the trustees of Trust 2, it will be worth less than its face value. If, as is likely, they realise a gain on repayment, the same problems as to the taxation of that gain arise as in scenario (a).

(c) Interest is payable on the loan at a commercial rate but the beneficiary entitled to the interest forgives it. While this does not have any income tax repercussions, there will be a plain reservation of benefit over the right to the debt under Finance Act 1986, section 102, so that this scenario is not viable.

(d) Interest runs at a commercial rate but is compounded annually and payable only on death.

If the interest is in fact paid, there will be a substantial charge to income tax. It may be that reliance will be placed on the interest never in fact being paid.[54] That is easier said than done.

If this scenario is relied on, there is a real risk that the amount outstanding on death will be greater than the then value of the home. This is a matter in which the trustees of Trust 1 will be personally and vitally interested.

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54 See *Dewar v IRC* (1935) 19 TC 561.

7.4 Stamp Duty

What of the stamp duty on the sale to trust A? It is possible to mitigate or delay, without the payment of interest or penalties, the payment of stamp duty on land transactions by relying on a suitable contract (not falling within paragraph 7 of Schedule 13 to Finance Act 1999) and not taking any formal transfer or other document that amounts to a stampable conveyance for the purposes of stamp duty. Contracts for the sale of legal interest in land are not subject to stamp duty, provided that the consideration is under £10,000,000. The charge arises only when there is a conveyance. Moreover, as the stampable document is (usually) the transfer, the late stamping penalties and late payment of interest charges arise only 30 days after the execution of the transfer and not from the time of the execution of the contract for sale: sections 15A and 15B, Stamp Act 1891.

It is necessary that the purchaser has an express or implied right to call for the transfer of the legal title into his own name. The fact that the parties do not intend to take a transfer is irrelevant as extraneous matters are excluded when construing the contract: *West London Syndicate v IRC* [1898] 2 QB 507, *Ingram v IRC* [1985] STC 835 and *Peter Bone v IRC* [1995] STC 921.

It is crucial that the contract does not provide that the vendor will hold the property on trust for the purchaser, or otherwise exclude the express or implied right of the purchaser to call for the transfer of the legal title in its own name.[55]

In addition, it is important that the contract should permit a sub-sale, since this is the only effective way of resolving the situation in the longer term.

7.5 Non-Tax Considerations

The scheme has two obvious advantages, if it works. Firstly, A will in principle have the right to occupy the home during his life. Secondly, if A wishes to buy a new home, the trustees of Trust 1 can sell the existing home and buy another one.[56]

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55 See generally *Peter Bone Ltd v Inland Revenue Commissioners* [1995] STC 921.

56 Until Parliament in its folly repealed the Settled Land Act 1925 as to future settlements, A could have created a settlement under that Act and reserved to himself the power of selling the old home and buying a new one. Trust 2 could still be set up so as to confer these powers on A. It would naturally require to be tailor-made and therefore be more expensive than if the Settled Land Act 1925 had not been repealed. (While the rule that one had to opt out of the Settled Land Act 1925 was inconvenient, Parliament should have allowed settlors to opt in to the Settled Land Act 1925.)

One practical problem is whether the trust fund of Trust 1 will be sufficient to pay the indebtedness when it is called in. If there is any doubt as to solvency, the persons who are trustees will be most concerned as to whether there is any risk of their being personally liable.

8 The Option Scheme

A scheme is sometimes proposed which involves the donor granting an option for a market consideration to the donee to purchase the home for an insubstantial consideration, the option being exercisable, say, in the period of three months beginning with the date of the donor's death. This involves there being no gift so that none of the gifts with reservation of benefit provisions can apply.

It is not obvious how such an option can be validly created if the home is situate in England and Wales, having regard to the Perpetuities and Accumulations Act 1964. Any promoter of the scheme should be asked how it deals with this point.

Another problem is that the price payable for the grant of the option may be more than the donee is able or willing to pay.

Stamp duty on the grant of the option must be taken into account. If the price is low enough, it may not be a problem.

The capital gains tax position is very interesting. The grant of the option is the disposal of an asset provided the option is not exercised. It is apparently suggested that this is still a disposal of an interest in the home itself so that if the home is the principal residence the grant will give rise to no charge to capital gains tax. Any one adopting the scheme would wish to ensure that such is the case.

Prima facie, if the holder of the option exercises it, the home will be disposed of by the personal representatives of the "donor". What consideration will they be deemed to receive for capital gains tax purposes? Is it the amount of the consideration for the option actually received by the deceased plus the amount of the strike price? Or is it the market value of the home at the time the option is exercised? If the latter, does such market value take into account the existence of the option? The next question would be " What is the personal representatives' base cost?". *Prima facie* it is the market value of the home at the time of the death. Would this valuation be on the basis that it is subject to the option?

Can one be sure that the disposal would be by the personal representatives, rather than by the deceased? Could the Revenue adduce arguments similar to those raised in *Jerome v Kelly* ?[57] Those arguments did not succeed before Park J but the Revenue has sought from the Court of Appeal permission to appeal that decision.

There may be ways of overcoming these problems if the home is settled *inter vivos* by the "donor", as an independent transaction from the sale of the option and/or if the option is not in fact exercised.

While such a strategy can perhaps work if the circumstances are right and it is properly thought through, there are many traps for the unwary.

9 Debt Based Schemes

A strategy which depends on leaving the home as an asset of the donor's estate but reducing its value for inheritance tax purposes by the creation of a debt has in principle much to commend it. As the home continues to belong to the donor, full capital gains tax principal residence relief is retained. Even if the home does not qualify for such relief, if it is retained until death, any inherent gain will then be "washed". The donor is still the owner of his home, subject, quite possibly, to a mortgage, yet this gives him much more flexibility, compared with other schemes, particularly if he wishes to move. He can use the borrowings to make gifts of personalty to which the gifts with reservation of benefit provisions do not apply.

One must ensure that the debt reduces the value of the donor's taxable estate rather than any non-taxable estate he may have, e.g. property qualifying for 100% agricultural or business property relief. Attention should be paid to Inheritance Tax Act, section 162.

The main disadvantage is the need to service the borrowing. If it is on commercial terms and at interest, this could be considerable, It would not normally be tax-deductible.

If the borrowing is from a connected person, one would need to ensure that the deductibility of the debt in computing the value of the donor's estate on death was not denied by Finance Act 1986, section 103.

The most efficient type of scheme is that which involves the donor using the borrowed funds to buy an interest in an excluded property settlement which then, in effect, becomes the creditor on the loan and charges the donor no interest.

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57 [2002] STC 609.

10 Spouse Exemption Trust

10.1 The Concept

It is usually possible to avoid the application of the gifts with reservation of benefit provisions by settling property on trusts under which one's spouse takes an initial interest in possession, as the gifts with reservation of benefit provisions do not then apply. See Finance Act 1986, section 102(5)(a), discussed at *The Family Home* 5.2.6.1. The Revenue did not share this view. Lightman J agreed with it in *IRC v Eversden* [2002] EWHC 1360 (Ch) [2002] STC 1109.

10.2 Which Trusts should Ensue?

What trusts are then to follow on the termination of the spouse's initial interest in possession? If there are discretionary trusts and the settlor/donor is left in sole occupation, there is a risk that the Revenue will contend that he has thereby become entitled to an interest in possession so that the whole point of the exercise is frustrated. This problem may not be so acute where an undivided share in the home is settled. Where the donor is permitted to occupy only in common with others, the risk of his being deemed to be entitled to *any* interest in possession in the settled property is somewhat reduced, though not eliminated. From a taxation point of view, the safest course is for the donor to provide that his beneficiaries will after a decent interval become absolutely entitled. They can then allow him to occupy the property on whatever terms they think fit.

10.3 Capital Gains Tax

The gift in settlement would not normally give rise to any charge to capital gains tax provided principal residence relief were available: Taxation of Chargeable Gains Act 1992, section 222. If not, it is unlikely after Finance Act 1989 that an election for hold-over relief on gifts could be made.[58]

If the home is not the principal residence of the donor and his spouse during the period that it is settled property, there could be a charge to capital gains tax on the rise in value of the home during this period, as after Finance Act 1989 no hold-over relief on gifts would normally be available on the termination of the settlement. If

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58 One cannot use an artificial scheme, such as that adopted in *Melville v Inland Revenue Commissioners* [2001] EWCA Civ 1247 [2001] STC 1271 (or any variant thereon which is proof against the Finance Act 2002 amendments to the Inheritance Tax Act 1984) to ensure that there is an initial small chargeable transfer of value as, in order to avoid the gifts with reservation of benefit provisions applying, the transfer of value must be an exempt one.

this gave rise to a problem, the trusts could be varied in a suitable way so that the donees did not become absolutely entitled on the termination of the spouse's interest in possession.[59] If the trusts then became discretionary and the trustees in the exercise of their discretion permitted the donor to occupy the property, principal residence relief from capital gains tax would *prima facie* be available to the trustees on a sale or other disposal of the property: see Taxation of Chargeable Gains Act 1992, section 225 and *Sansom v Peay*.[60]

If the trustees permitted the donor to occupy the whole of the property in common with other beneficiaries, then, in the author's view, principal residence relief would be available as respects the donor's period of occupation notwithstanding that he was only one of several occupiers. This follows from the strict wording of Taxation of Chargeable Gains Act 1992, section 225. By contrast with the case where the donor was the sole occupier, even if the Revenue could establish that the donor had thereby become entitled for an interest in possession, that could only be as respects a part of the settled property, reflecting his shared occupation: see Inheritance Tax Act 1984, section 50(5).

If after the termination of the interest in possession the property continued to be settled but the settlor was not a beneficiary, his occupation being referable to the licence of a beneficiary, there would be no capital gains tax relief available to the trustees on a disposal by them.

10.4 Gifts of Limited Interests

It may well be that the best strategy would be for the home to be gifted to a trust under which there are two funds. Each fund would own a limited interest in the property. For example, Fund A could own a lease and Fund B the reversion or Fund A could own the freehold and Fund B a reversionary lease. When the gift was made, the spouse would have an interest in possession in both funds but in due course her interest in Fund B would be terminated. It would not matter greatly if she and the donor had an interest in possession in Fund A, as the asset would be a wasting asset and only its value on the death of the spouse (or, on one variant, the donor) would be brought into charge to inheritance tax. Provided Fund B continued to be settled property, the trustees should benefit from the capital gains tax principal residence exemption as respects both of their interests in the home during the period

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59 The termination of an interest in possession in settled property does not, even post Finance Act 1989, give rise to an occasion of charge to capital gains tax unless the property thereupon ceases to be settled.

60 [1976] STC 494.

it was the spouse's principal residence.

11 Unattractive Options

11.1 Introduction

In this section I simply list certain options which are not recommended. For the reasons for my rejection, see *The Family Home* 10.11.

11.2 Absolute Gift

Suppose that a donor gifts his home to a donee absolutely and continues to live there as the gratuitous licensee of his donee. The donor will have made a disposal of property by way of gift with a reservation of benefit. The gift will still be taxable in principle when it is made. But it will also be taxable on the donor's death under the gifts with reservation of benefit provisions unless the reserved benefit has ceased more than seven years before his death.[61]

11.3 Gift in Trust

11.3.1 Interest in Possession for Settlor

In the author's opinion, it is not normally possible for a person to settle his home upon continuing trusts which will effectively take it out of his estate for inheritance tax purposes while at the same time continuing to occupy it. That is not to say that the desired result may not be achieved by the home technically remaining part of the estate but by the home or the estate being devalued by a deductible debt or encumbrance.

11.3.2 Discretionary Trust

If the donor settles the property on trusts which are in part discretionary and he is an object of the trustee's discretion, the Revenue will undoubtedly claim, correctly or incorrectly, that there is a reservation of benefit vis-a-vis the entire settled property.[62]

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[61] While relief may well be due under The Inheritance Tax (Double Charges Relief) Regulations 1987, SI 1987/1130, the Revenue will extract the larger amount of tax.

[62] See *The Family Home* 5.6.5.

11.4 Companies

11.4.1 Inheritance Tax Advantages

It might be asked whether it would be a useful tax planning exercise for a donor to transfer his home to a company. The company's ordinary share capital would be split into two, A shares and B shares. The donor would retain the A shares and gift the B shares to his son. The disposal of the home to the company would be for full consideration consisting of an issue of shares by the company. The only gift would therefore be of the B shares, and that would in principle qualify as a potentially exempt transfer. The donor would continue to occupy the home, probably by virtue of rights attached to the A shares.

The arrangement does not appear to fall foul of Finance Act 1986, section 102, section 102A or section 102B.

11.4.2 Capital Gains Tax Drawbacks

Such arrangements are not advantageous from the point of view of tax on capital gains.

11.4.3 Income Tax Disadvantages

Income tax consequences of the arrangement must be carefully scrutinised too. If the donor is an employee, director or, since the decision of the House of Lords in *R v Allen,*[63] a shadow director[64] of the company, then the statutory value of his beneficial occupation of the home will be assessable to income tax under Schedule E.

12 Joint Ownership

12.1 Forms of Joint Ownership

Joint ownership of English land can take two forms: joint tenancy or tenancy in common. If the owners are to have different shares, the ownership must be through

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63 [2001] UKHL 45 [2001] STC 1537.

64 For the extended meaning of this term, see *Secretary of State for Trade and Industry v Deverell* [2001] Ch 340, [2000] 2 All ER 365, CA, discussed in my *Non-Resident Trusts* 8th Edition 9.3.2.3.

a beneficial tenancy in common.[65] The land law background is extremely complex. If the tax adviser is not a lawyer, the services of a lawyer who understands both the land law and the tax will be indispensable.

12.2 Gift on Joint Tenancy

If the donor, being the sole owner of land, by gift creates a joint tenancy in favour of himself and the donee, Finance Act 1986, section 102B will not be in point (as he will not have gifted an undivided share in land) but section 102 or section 102A could be.

Let us consider firstly section 102, which operates in priority to section 102A. It is thought that provided the donor shares occupation jointly with the donee and bears his proper shares of outgoings, there will be no problem. Where the donor is in sole occupation, the position is much more complex. It is arguable that since the coming into force on 1st January 1997 of the Trusts of Land and Appointment of Trustees Act 1996 and in the light of the decision of Lightman J in *IRC v Eversden* [2002] EWHC 1360 (Ch) [2002] STC 1109 (a case which in fact concerned a tenancy in common) there is no reservation of benefit, especially if he bears all the outgoings of an income nature. It is, however, possible that in such a case the donee could obtain from the court an order for sale or an order from the trustees for the donor to pay the donee compensation. Failure to seek to obtain either or both of these orders could be construed as the conferring on the donor of a benefit within section 102.

Even if section 102 does not apply, section 102A is potentially in point. There are only two possible defences. One will be the section 102A(5) one of seven years prior ownership by the donor. It is arguable that the interest of the donor as a joint tenant is not the same interest, or part of the same interest, as that to which he was entitled when he was the sole owner. If that is correct, the defence would not be applicable.

The only other defence is that the donor has given full consideration.

The decision in *IRC v Eversden* [2002] EWHC 1360 (Ch) [2002] STC 1109 was in relation to a gift made before the Finance Act 1999 changes. It is considered that

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65 At law, there can be only a joint tenancy.

it will not be relevant to a gift of an undivided share in land made nowadays.[66]

12.3 Gift of Undivided Share

If the donor gifts an undivided share in land, then Finance Act 1986, section 102B will *prima facie* apply.[67] The interest gifted will be property subject to a reservation unless one of three defences can be made out. The first, non-occupation by the donor, is not in point. The second is where the donor occupies the land to the exclusion of the donee for full consideration in money or money's worth. See *The Family Home* 5.11.5.4 for the difficulties of interpretation of that phrase. Given the uncertainties, this is unlikely to be a promising avenue.

The third defence applies where the donor and the donee occupy the land and the donor does not receive any benefit, other than a negligible one, which is provided by or at the expense of the donee for some reason connected with the gift. This may be a viable option in some cases. See *The Family Home* 5.11.5.5.

It is possible that section 102B will not apply, so that there is nothing to stop section 102 or 102A applying. On when section 102B "applies", see *The Family Home* 5.11.6. Section 102B will not apply if there has been no disposal of an undivided share of an interest in land. See *The Family Home* 5.11.7.2. Suppose the donor has gifted cash to trustees which they use to purchase an interest in land together with the donor as tenants in common. Section 102 can apply in such a case (although it is considered that section 102A cannot, any more than section 120B).

It is thought that, provided the donor shares occupation jointly with the donee and bears his proper shares of outgoings, there will be no problem. Where the donor is in sole occupation, the position is much more complex and is in principle similar to the case where there is a joint tenancy and the donor remains in exclusive occupation. There are two differences. Firstly, the smaller the share of the donor, the more likely it must be that the court would order a sale or the trustees would order compensation to be paid. Secondly, it is more likely that the effecting of the purchase by the trustees could be said to be a breach of trust and the conferring of a benefit on the donor which would bring section 102 into play.

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66 It could conceivably be relevant where a gift is made other than of land and where the gifted property (or property representing it) is later invested in acquiring an undivided share in land.

67 On when section 102B will "apply", see *The Family Home* 5.11.6.