The Personal Tax Planning Review

THE HOME: INHERITANCE TAX AND CAPITAL GAINS TAX TREATMENT ON LIFETIME SITUATIONS

Ralph Ray[1]

(All statutory references are to the Inheritance Tax Act 1984 unless otherwise stated)

This subject was considered in connection with **death** situations in Volume 4 1995/96 Issue 1 pages 51/56.

This article covers the subject from a **lifetime** viewpoint. The main problem is for the estate owner to retain possession without falling foul of the IHT gift with reservation provisions.

The simplest method would be for the estate owner to "trade down", namely to sell the home, buy a smaller, cheaper house and with the cash availability make appropriate PETs. Subject to that there are various possibilities of giving away an interest in the home, staying in occupation and avoiding the gift with reservation liability. Six of these are analysed below.

1. Lease carve out

The estate owner could arrange to retain a lease or tenancy in the home for a period of years. This must not be a lease/tenancy **for life** because that would constitute a settlement, with the result that on the estate owner's death, the full capital value of his/her home would be assessed to IHT. This has received recent judicial support in the *Ingram* case; see (e) below.

[1] Ralph Ray FTII BSc(Econ) Partner, Shoosmiths & Harrison, Solicitors, Russell House, Solent Business Park, Fareham, Hants PO15 7AG. Tel: (01489) 881010 Fax: (01489) 881000.

The principle is that the lease **retained** is not a gift and, therefore, not a reservation of benefit (cf *Munro v Stamp Duties Commissioners* [1934] AC 61 and *Chick v Stamp Duty Commissioners* [1958] All ER 623). The great advantage of this method is that it is not essential to pay a realistic market value rent (although that would give a second "belt and braces" protection against a gift with reservation attack). Having carved out the lease/tenancy, the estate owner gives away the remaining ownership in the home. The suggested arrangement could go as follows:

(a) Identify the freeholder. A freeholder cannot just grant a lease to himself, so will have to transfer a share to someone else, for example a spouse. Following the Scottish Court of Session's decision in *Kildrummy (Jersey) Limited v IRC* [1990] STC 657, the use of a **nominee** lessee may be dangerous insofar as the Court may be able to ignore the existence of such nominee holding, that situation coupled with the decision in *Rye v Rye* [1962] 1 All ER 146 to the effect that a person who is the freeholder cannot grant a lease to himself, may nullify the whole transaction. The co-lessee's interest should, therefore, be a beneficial interest, albeit of a relatively small share, say 10%. Alternatively, the nominee could hold the lease beneficially as to X% for the donor and Y% for another, say the donor's spouse. Note, however, how the situation was covered in the *Ingram* decision: (e) below.

(b) Having resolved any problems raised at (a), the owner can then grant a requisite lease, rent-free if wished, for long enough to cover his life expectation (and spouse's, if relevant), with a bit to spare. A 65 year old male would have an actuarial expectation of 15 years, so the lease should be for, say, 20 or 25 years. Clearly the lease should not be unnecessarily long because the longer it is, the greater the value of the unexpired lease in the estate of the lessee on death and hence the liability to IHT. Nor should it be too short, because the estate owner may then outlive the length of the lease.

(c) The estate owner can then make a gift of the freehold (subject to the retained lease) to his children or other family members or to a family trust (particularly the favoured accumulation and maintenance trust - under s.71).

(d) Where the estate owner already owns a long leasehold interest, the plan can be adopted by way of a carve out of a shorter sub-lease, subject to obtaining any requisite landlord's consent.

Possible disadvantages of the carve out method:

- The recipients would not benefit from the capital gains tax ("CGT") main-residence exemption and the eventual CGT is likely to be high because of the relatively low base value at the time of the gift. The CGT rate could be restricted to 25% if the recipients are trustees of an interest in possession trust (this would also be relevant to the reversionary lease scheme in 4 below).

- There could also be an income tax disadvantage relating to lease premiums (Taxes Act 1988 s.35) if the property were sold whilst the lease was still in force. This applies in respect of the assignment of the lease and it appears that a **surrender** of the lease would be unobjectionable. The surrender should be to the **purchaser** of the freehold.

- There is also a possibility that the Revenue might apply the **associated operations** provisions (s.268), contending that the carving out of the lease (followed by the subsequent gift of the freehold reversion) was not a "prior independent transaction". The Revenue based this argument on the Court of Appeal decision in *re Nichols deceased* [1975] STC 278. However, this was not a carve out but a gift back and the *Nichols* decision was not applied in the *Ingram* case (see (e) below). It is understood the Revenue are considering this line of attack more closely! Clearly the two transactions should be as independent as possible and with no obligation to undertake the second after the first. The risk of an assessment as an "associated operation" is reduced if the residue of the lease is left to someone **other** than the donee(s) of the freehold reversion, e.g., to a grandchildren's Accumulation and Maintenance or a discretionary trust. Therefore, the interests of the lease and freehold should **not merge** on the estate owner's death.

(e) Lease carve-outs - taxpayer narrowly wins in the High Court decision in *Ingram v Commissioners of Inland Revenue* [1995] STC 564

Mr Justice Ferris decided in favour of the taxpayer, being the estate of Lady Ingram, widow of Sir Herbert Ingram. It is understood that the Revenue intend to appeal.

Under the lease carve-out scheme as has been typically executed over the years, the estate owner carves out a rent-free lease for himself for a term of years (long enough to "see him out"); and gifts to others, e.g., children or an appropriate family trust, the freehold reversion subject to the retained lease. On the subsequent donor's death it is then claimed that the remaining term of the retained lease has little value in the donor's estate.

The Revenue have consistently argued, however, that the arrangement is ineffective as constituting a **gift with reservation** (FA 1986 s.120 and Sch

20), coupled with the associated operations provisions in IHTA 1984 s.268. The Revenue practice has been only to allow the arrangement (and not charge the **full** value of the property), if the lease carve-out was a "**prior independent transaction**" not tainted with the gift of the reversion. (This is invariably a difficult line for the taxpayer to argue.) However, as mentioned in *Green's Death Duties* 7th edition page 143 "**what a donor keeps back [eg the carved out lease] is no gift**" - following the dicta of Lord Radcliffe in *St Aubyn v A-G* [1951] 2 All ER 43.

The lease arrangements in *Ingram* were unusual and did not follow the typical circumstances referred to above. The *Ingram* arrangements were cleverly constructed, it is understood, by Robert Venables QC. Under the Scottish decision in *Kildrummy (Jersey) Limited v Commissioners of Inland Revenue* [1990] STC 657, a freeholder cannot effectively grant a lease to himself and a gift by a freeholder to a mere nominee of his does not alter this position. Likewise, a nominee cannot effectively grant a contractual lease to his principal.

In the *Ingram* case, the following steps took place.

- Lady Ingram gave the freehold estate to her solicitor as a bare trustee for her;

- on the next day the solicitor granted Lady Ingram a 20 year lease rent free.

- Shortly thereafter the freehold reversion was transferred to new trustees by declaration of trust on absolute interests and on an accumulation and maintenance trust for Lady Ingram's children and grandchildren respectively.

When Lady Ingram died unexpectedly after 2 years, it was contended by her executors that the value of the property in her estate was merely the unexpired term of the lease. The Revenue contended that the **full freehold value** of the estate should be assessed and that the decision in *Kildrummy* applied whether the transfer was to a trustee or a nominee.

The main aspects of Mr Justice Ferris' judgment:

- He accepted the Revenue's argument in part by rejecting the validity of the **actual** contractual lease; and he could draw no distinction between a gift to a nominee and a gift to a trustee in the *Kildrummy* context, on the basis that a person cannot contract with himself.

- However, he acknowledged the existence of a **deemed equitable lease** on the footing that, as the donor only intended to give the freehold reversion, she must have retained a deemed equitable lease. To put it another way, and in the words of Mr Justice Ferris, Lady Ingram "took her leasehold interest in equity.... the gift made by her was the property shorn of those leasehold interests". The retained lease and the gift of the reversion were **two separate assets**: the former was not part of the gift. The *Nichols* decision referred to above was not applicable.

- Mr Justice Ferris was unimpressed with any *Ramsay* argument; the arrangement certainly had enduring results! Moreover, for the *Ramsay* argument to succeed it would have required the leasehold interest to arise **after** the unincumbered transfer of the property to the trustees and the beneficiaries: this was clearly not the case.

Practitioners must watch this space in respect of the pending appeal.

2. A "commercial lease" FA 1986 Sch 20 para 6

A second possible arrangement is to pay a full arm's length rent for the lease or tenancy retained. Such a rent would need to be reviewable upwards, say every three or five years, in the light of changing conditions and inflation and certified by a qualified surveyor. The creation of such a new source of taxable, non-deductible income can be very disadvantageous (although the taxable receipt problem may be solved by using a grandchildren's accumulation and maintenance trust under s.71). Moreover, the estate owner's income will be reduced. The proposal may be more acceptable for an older estate owner (i.e., where there would be less emphasis on rent reviews). Note, however, that although the gift with reservation rules will not apply, the PET 7 year requirement will apply.

3. A sale subject to a favourable lease retained

Another method is to sell the home, e.g., to a member of the estate owner's family, but subject to retaining a lease/tenancy for an appropriate number of years. Under this retained lease the estate owner need not pay any rent. This will reduce the sale price fetched for the home - it will not have vacant possession value because it is subject to the lease/tenancy retained. While the foregoing involves reservations it does not involve a disposal "by way of gift" and therefore escapes s.102. It may be possible to allow a friend or relative purchasing to pay the purchase price by instalments; however, this proposal is more likely to be attacked by the Inland Revenue as being an "associated operation". Certainly the purchaser should provide the purchase price out of his own resources or by way of mortgage. This is **outside** the PET regime because a sale is involved.

A variant of this arrangement would be that the terms of the sale would include a grant back of the lease for life at a nominal rent. Section 43(3) should prevent the lease being a "settlement" as the arrangement is for full consideration. (See also Statement of Practice SP10/79.)

4. Reversionary lease

The owner could retain the freehold and grant a long term, e.g., 999 year lease at a nominal rent **to arise after a specified number of years in the future, preferably not exceeding 21 years**. That number of years would be gauged to give the estate owner the required length of occupation as freeholder. As mentioned under 1(d), the freehold interest and the reversionary lease should not merge on the owner's death.

As the lease will be for more than 50 years, the income tax problems under TA 1988 s.35 (referred to in 1 above - lease carve-outs) will not apply.

The great advantage of this method over the lease carve out is that there is a **single** transaction and therefore much less likelihood of a Revenue attack under the "associated operations" provisions in s.268. The Revenue may try to argue that because the donees do not go into actual physical possession, the gift with reservation rules apply. This is considered to be an incorrect analysis because the donees have an asset, namely the reversionary lease, which they can sell, assign, gift, charge or otherwise dispose of even though they are not and cannot be in physical possession until the lease falls in.

5. Sharing the home

The owner could retain a share of the home - say a third or a quarter - and give the rest to his children or to trustees of a children's settlement so that the owner and the donee(s) are occupying and sharing the home as "tenants in common" or as "joint tenants". Each joint owner must **occupy** the home and pay his due share of the running costs and expenses such as insurance, repairs, decoration, council tax. This method is based on a Hansard statement on 10th June 1986 as follows:

> "...it may be that my Hon Friend's intention concerns the common case where someone gives away an individual share in land, typically a house, which is then occupied by all the joint owners including the donor. For example, elderly parents make unconditional gifts of undivided shares in their house to their children and the parents and the children occupy the property as their family home, each owner bearing his or her share of the running costs. In those circumstances the parents' occupation or enjoyment of the part of the house that they have given away is in return

> for similar enjoyment of the children of the other part of the property. Thus the donors' occupation is for a full consideration."

Moreover, the Inland Revenue have since confirmed that this principle applies notwithstanding that the co-owners do **not** share equally (see the *Law Society's Gazette* 1st June 1988 p 35).

This method may be particularly appropriate where a bachelor son/daughter is living in the parental home, which situation is likely to last indefinitely.

The practical problem is that, if the estate owner's children already have their own homes, the necessary element of sharing the home with them is absent. Moreover, if the home was initially shared and the children later moved away, the owner would have to pay a full rent for the property from then on, or be seen as starting a reservation of a benefit. This problem, namely of a gift with reservation arising, could be avoided by the child who is about to move out granting the parent a life interest in his undivided share with remainder to the child. On the parent's death, (providing the child has survived) there would be an IHT exemption under s.54(1), namely the reverter to settlor exemption.

It is possible to apply this principle to **holiday homes** and **pied à terre** (but in such cases the only or main residence rule for CGT exemption on the gift/transfer/disposal will not apply). The Revenue's views as to the existence of a gift with reservation for second homes or holiday homes referred to in the Bulletin of November 1993 should not, it is considered, apply where there is a **joint ownership** in the context of the Hansard statement referred to above. Be careful, however, to ensure that the actual use of the property is **commensurate** with the share of ownership. For example, if the donor retains a 20% share in the property, and occupies it for 75% of the time, there could well be a **gift with reservation**.

6. A gift of cash

It may be possible to base an arrangement on a **gift of cash**. For example, the estate owner could give his son £100,000 with which he buys a home where they both then live. The reservation of benefit rules do not apply to such an **outright** cash gift or the proceeds. The gift must be an absolute, outright gift - **not** into settlement; FA 1986 Sch 20 paras 2(2) and 5.

It would be too risky and unrealistic, however, if the cash were used to buy the owner's existing home; the Inland Revenue could attack that as an associated operation or on the grounds of the arrangements being too artificial.

A judicious interval should elapse between the time of the cash gift and the start of occupation of the new home, say six months, and preferably straddling an April 5th tax year end.

In applying these six possibilities, also consider the possible effects of other taxes, particularly CGT, as the recipients of the gift cannot nominate the house as their main residence (- except in case 5 and probably 6 above). Income tax on rent may also be a factor (see also under 2 above).

As IHT is relatively new, there is always the possibility that the Inland Revenue may attack arrangements on the basis that they are associated operations - an indirect form of giving - or that they are entered into purely for the purpose of avoiding tax or that the arrangements are a sham.

Finally, two ancillary situations are analysed:

THE SECOND HOME IHT AND CGT

- As to CGT, consider the use of a discretionary trust of the nil band(s) (e.g., of husband and wife donors), the trustees entitling the beneficiary to occupy as a main residence and, on a sale, claiming main residence exemption under TCGA s.225 (also s.222 where the trustees **appoint** out to the beneficiary, holding over the gain; and the beneficiary sells). Note, moreover, under current rules (TCGA s.223), provided the house has been so occupied as a main residence, the last **36 months** will automatically qualify for relief. This suggestion was threatened by the Consultative Document on UK Trusts of 19th March 1991, but it now seems unlikely that the provisions of the Consultative Document will be enacted under the **present** government.

- Trustees transfer out the house to, say, six beneficiaries as tenants in common. Trustees elect for CGT hold-over under TCGA s.260. Trustees are operating within nil band, therefore no IHT, and the six beneficiaries may each have his/her CGT annual allowance of £6,000 available. (Can save £14,400.)

- Consider adapting this method of interposing a discretionary trust for **other investments**, e.g., quoted shares.

STAMP DUTY AND THE MORTGAGE TRAP

As is well known, gifts have been exempt from stamp duty since 1985. The snag/trap referred to arises, however, where property (e.g., a home) is gifted from

A to B (including between spouses) subject to a **mortgage**. Under Stamp Act 1891 s.57 the debt (mortgage) **assumed by the donee** is **consideration** liable to 1% ad valorem stamp duty. For further details see Inland Revenue Statement of Practice SP 6/90 dated 27th April 1990.

Where a certificate of value that this consideration does not exceed £60,000 (FA 1958 s.34(4) as amended) can be given, the problem is solved.

Although the home is frequently regarded as a sacrosanct asset not to be used lightly for estate planning purposes, it is often the major asset in the family. This article and the previous article referred to indicate the possibilities which the estate owner must duly weigh up.