
The Personal Tax Planning Review

GIFTS WITH RESERVATION - TWO PROBLEM AREAS - PART I

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It is rare for the draftsman of the Finance Bill, when seeking to counter a perceived mischief, to devise a formula of words which has not been used before. More often than not the Parliamentary intent will be achieved by adapting a form of words used in an earlier Act to the needs of the present. But it is unusual to find Parliamentary plagiarism on the scale found in section 102 of the FA 1986 and the supplemental Schedule 20. These provisions, conceived in haste to forestall undue advantage being taken of the new relief accorded to "potentially exempt transfers" ("PETs"), were lifted wholesale from the Estate Duty Acts (mainly s.2(1)(c) FA 1894 (and provisions referred to therein), s.59(3) F (1909-10) A 1910, s.38 FA 1957 and s.35 FA 1959). They were transplanted by the draftsman in the alien territory occupied by inheritance tax. How successful is the transplant?

It might be thought that with apparently respectable Estate duty antecedents, precedent in the form of the large number of decisions on similar provisions dealing with "reservation of benefits" found in the legislation of the United Kingdom and the former Dominions would afford a complete answer to most if not all the questions likely to arise. The reservation of benefit provisions in s.102 achieve and are intended to achieve a broadly similar object to their Estate duty predecessors. So it is right to conclude that once well known authorities such as *Munro v Stamp Duties Commissioner (New South Wales)* [1934] AC 61 and *Commissioner for Stamp Duties for New South Wales v Chick* [1958] AC 435 will provide a guide as to how the new provisions are likely to be interpreted by the Courts.

But only a modest proportion of the questions likely to arise can be answered by reference to the Estate duty cases. First, only a fraction of the questions to which the Estate duty "reservation of benefit" rules gave rise came to be answered. Even where answers were provided the precise scope of their application remains uncertain. Nowhere is this better illustrated than by the decision of the Court of

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Appeal on the unsuccessful "shearing" operation in *IRC v Nichols* [1975] STC 278 and the uncertainty to which the reasoning of Goff J delivering the judgment of the court in that case has given rise.

The second reason why the decisions on the old law afford only limited guidance stems from the essentially different conceptual basis of inheritance (or capital transfer) tax and Estate duty. Estate duty was a charge on property "passing" or deemed to "pass" on death. As a result of the changes introduced by the FA 1986 death will in many cases be the only occasion for a charge to inheritance tax. But the basis of that tax was and remains the "transfer of value" measured by reference to the diminution in the value of property to which a person is beneficially entitled (his "estate") rather than on the value of property "passing" on a death. In s.102 Parliament has imported into inheritance tax a concept and expressions intended to give effect thereto which developed under the essentially different Estate duty regime. Thirdly, as the second instalment of this article will demonstrate, the new rules are in no way as comprehensive as the reservation of benefit rules found in the estate duty legislation.

This article explores just two of the problem areas to which s.102 gives birth. The first (considered in this issue) might not be thought to be a problem area. Indeed the answer to at least one of the questions raised is so obvious to the writer as to suggest that those of the opposite persuasion are naive. Nonetheless there is some suggestion that the Revenue take the opposite view. So the point is worthy of comment.

Cash Gifts - Does s.102 Apply?

Consider the following situation:

A donor (D) gives to the donee (X) the sum of £100,000. X expends the money in purchasing a dwelling-house (Blackacre). X allows D into possession of Blackacre free of rent.

That is perhaps the most simple factual situation likely to be met. Is Blackacre to be treated as comprised in the estate of D under the reservation of benefit provisions found in s.102?

Taking s.102 itself the answer is plainly "no". The section refers to a case where an individual (D) disposes of "any property" (£100,000) possession of which is not *bona fide* assumed by the donee, or the property (£100,000) is not enjoyed to the entire exclusion of the donor and of any benefit to him by contract or otherwise. One would have thought it plain that if a benefit is to be reserved it must be reserved out of the property which is the subject matter of the gift - not property

purchased with the gifted cash or substituted for any other property gifted. In the example the property (that is the cash sum of £100,000) is enjoyed to the exclusion of D. It is Blackacre which was purchased by X with the assistance of this sum which is enjoyed by D. Blackacre was not the property comprised in the gift. So the reservation of benefit rules cannot bite. Can the opposing view be sustained?

The Purpose of the Gift of Cash

It is possible by varying the facts to envisage situations under which Blackacre might be caught by the reservation of benefit provisions of s.102. What, for example, is the position if the cash was to be gifted by D with the express object of enabling X to complete a contract to purchase Blackacre, *a fortiori* if X had contracted to purchase Blackacre from D? Is the property gifted in such a case to be treated as Blackacre rather than the cash? What if the evidence surrounding the gift showed that it was almost inevitable that the cash gift would be utilised in the purchase of Blackacre (compare *Hatton v IRC* [1992] STC 140)? It will not necessarily follow that s.102 will apply in every cash where it was preordained that the donee would apply the gifted cash in the purchase of property out of which the donor subsequently reserves a benefit. The crucial question in each case is to identify the subject matter of the gift. The fact that it was virtually inevitable that the donor's cash was to be applied in a particular way is only relevant in so far as it serves to identify the subject of the gift.

In such marginal cases limited guidance can be found in the Estate duty cases. It is limited because the authorities themselves leave room for confusion and because some, at least, were not directed to the question raised here, that is the identity of the property given.

Thus in *Sneddon v Lord Advocate* [1954] AC 257 the payment of a cheque by a donor to allow the donees (trustees) to subscribe for shares in a company which they did 3 days later was held to be a gift of cash rather than the shares. That decision was inevitable. The shares did not exist as an item of property when the gift of cash came to be made.

That decision was followed on more marginal facts in a Scottish case, *Potter v IRC* 1958 SLT 1958. There, the crossed cheque handed to the donor's son by the donor was made out in favour of the company in which the son was to subscribe for shares. The principle on which this decision proceeded was that it was only the property which the deceased himself owned and transferred which was dutiable (or in the case of s.102 could be the subject matter of the gift). The shares for which his son subscribed, but which were paid for by him, were never owned by the deceased donor and could not therefore be the subject matter of the gift.

Potter was, however, itself distinguished in *Ralli Bros Trustees Ltd v IRC* [1968] Ch 215. In that case the donor wished to effect and settle endowment policies for the benefit of her family. The five settlements made by her each contained a covenant to effect the policy in the name of the trust company which was duly done. Payment for the first premiums due, however, was by cheque drawn on the bank account of a company which in turn debited the donor. On these facts the gift was held to be one of the policies and not of the £100,000 cash expended on the first premiums.

The decision puts a gloss on the principles on which *Sneddon* and *Potter* were decided. It is not necessary for the donor to own the property which is the subject matter of the gift in every case. If he contracts to purchase property or hands purchase money to the owner of property and directs the conveyance or transfer of that property into the name of the donee there will be a gift of the property rather than cash. In such cases the reservation of benefit rules may bite if the donor reserves to himself a benefit out of the subject matter of the gift or any property treated as substituted therefor under the provisions of paras 2-4 of Sched 20 FA 1986.

On the basis of these authorities I do not consider that a sum gifted by D in the example cited above merely to facilitate X's completion of the purchase of Blackacre from an outsider is other than a gift of the cash. Accordingly, the reservation of benefit provisions would not bite in such a case where D subsequently enjoyed the benefit of rent-free occupation of Blackacre. If, however, D paid the balance of the purchase money to the vendor himself, all the more so if he himself had contracted to make the purchase, the subject matter of the gift would be Blackacre rather than the cash. The same result is likely to follow if the payment of cash was on terms which placed X under a legally binding obligation to expend the same in the purchase of Blackacre. In such cases the reservation of benefit provisions may come into operation in respect of any benefit enjoyed by D in Blackacre.

Exceptionally s.102 will apply to what are arguably gifts of cash. If D assigns the amount standing to his credit at a bank to X and X then directs the bank to pay the interest otherwise accruing to D, the amount standing to the credit of X will be caught by the reservation of benefit rules on D's death (see further below). In such cases the reservation of benefit will be out of the property gifted.

Relationship with s.103 FA 1986

In other cases s.103 FA 1986 may deny to a donor the benefit likely to be obtained by making an exempt transfer or a PET attributable to money whilst continuing effectively to enjoy the same. Of course, s.103 operates in a different manner

from s.102. It operates by denying to the donor/debtor the right to deduct a debt (say a loan) in arriving at the value of his inheritance tax estate where the debt was derived from property provided by the donor/debtor. It was intended, at least in part, to counter arrangements involving the systematic exploitation of the annual exemption by the making of gifts of £3,000 which were immediately loaned back to the donor.

But s.103 is equally capable of countering and is intended to counter arrangements intended to take advantage of the relief accorded to PETs by the utilisation of cash gifts. If to take the simple case described above, X was not to spend the gifted cash in the purchase of Blackacre but was to lend a sum equal to that gifted to D, D (or his personal representatives) would not be entitled to deduct the money lent in arriving at the value of his estate. The cash gifted would not be caught by s.102 because the "property" which the donee X enjoys is not the cash which he has lent to D, but the debt which is substituted for that cash. The position is no different from that considered above where the cash gift is applied in the purchase of property which is then enjoyed by the donor.

Effect of Sched 20 FA 1986

The view of s.102 taken in isolation is reinforced when Sched 20 comes to be considered. The wording of Sched 20 is, with minor adaptations, identical to that found in s.38 FA 1957 and s.35 FA 1959 relating to Estate duty. S.38 was intended primarily as a means of identifying gifted property "passing" on the death of a donor who had died within 7 years of making the gift. Under the Estate duty regime alterations and substitutions in the property between the gift and death had to be taken into account because the gifted property was to be valued at the date of death. This is not, of course, the case when a PET becomes chargeable. In such cases the value transferred has to be calculated at the date of transfer - changes between transfer and death being largely - although not for all purposes ignored. But s.38 FA 1957 also provided a means of identifying the gifted property for the purpose of determining whether a benefit was reserved in that property. That clearly is the purpose of Sched 20 - at least in all cases where there has been some alteration to or substitution for the property comprised in the original gift.

The key rule is to para 6(2) of Sched 20 which provides:

"Any question whether any property comprised in a gift was at any time enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him shall (so far as that question depends upon the identity of the property) be

determined by reference to the property which is at that time treated as property comprised in the gift."

This repeats s.38(13) FA 1957.

It is clear from this that Sched 20 is not limited in its scope to the identification of the gifted property for valuation purposes. Indeed, to claim that it was so limited would be to put the cart before the horse - or perhaps to do without a horse at all. For until the property comprised in the gift is identified it will be impossible to say whether a benefit has been reserved to the donor. Without such reservation there is no requirement to value the property at all at the date of the death of the donor reserving the benefit, for the value transferred by the PET is to be calculated at the time of transfer - not at the time the PET becomes chargeable.

In the case of gifts other than cash (and settled property - see below) the substitution of some other property out of which a benefit may be reserved for the property which was the subject of the gift will no more allow the donor to escape the reservation of benefit rules than did similar substitutions for the purposes of Estate duty. For inheritance tax purposes para 2(1) of Sched 20 provides:

"Where there is a disposal by way of gift and, at any time before the material date [usually the death of the donor] the donee ceases to have the possession and enjoyment of any of the property comprised in the gift, then on and after that time the principal section and the following provisions of this Schedule shall apply as if the property, if any, received by the donee in substitution for that property had been comprised in the gift instead of that property (but in addition to any other property comprised in the gift)."

This is modelled in part on s.38(1) FA 1957

It would hardly be necessary to provide expressly for the substituted property to be the property out of which the benefit was to be reserved if it was implicit in s.102 itself that the charge would attach in all cases where the benefit was reserved out of property substituted for or derived from the gifted property.

Para 2(3) of Sched 20 provides that references to property received by the donee in substitution for property comprised in the gift "includes in particular"

- "(a) in relation to property sold, exchanged or otherwise disposed of by the donee, any benefit received by him by way of consideration for the sale, exchange or other disposition; and

- (b) in relation to a debt or security, any benefit received by the donee in or towards the satisfaction or redemption thereof; and
- (c) in relation to any right to acquire property, any property acquired in pursuance of that right."

This repeats s.38(2) FA 1957.

Sub-para (1) and (3) of para 2 create a potential no man's land for dispute between the Revenue and the taxpayer. Do they allow for one substitution only or is property which is successively substituted for the property referred to to be included? The better view is the former. The words "that property" in para 2(1) of Schedule 20 can only refer to the property which was the subject of the gift - not any substituted property. It would have been a simple matter to provide for successive substitutions if that had been intended: viz, by referring to "property directly or indirectly representing or derived from the property comprised in the gift." Nonetheless, a limitation of the extension to the first substitution will severely restrict the ambit of the section. If the gifted property is sold for cash it is improbable that a benefit would be reserved out of the actual consideration received on the sale (the first substitution). If those proceeds are then applied in the purchase of other property (the second substitution) which is then enjoyed by the donor, that property would on this preferred interpretation not be treated as property comprised in the gift. So the donor enjoying a benefit out of the property purchased will escape the reservation of benefit trap. The Inland Revenue may well resist such a conclusion.

But for immediate purposes para 2(3) is relevant only in so far as it throws light on the question of whether property purchased with a gifted sum or money can be treated as the gifted property for the purposes of s.102. For these purposes para 2(3) is of marginal significance in two respects: (a) whether the reference to a "debt" in para 2(3)(b) can include a credit balance at a bank - for if it does that may have a bearing on the meaning to be given to a "sum of money" in para 2(2) considered below; (b) the reference to "consideration" for a sale (usually in cash) shows that Parliament has not shrunk from the possibility of assuming that a benefit can be reserved out of cash - whether mixed with the donee's own monies or not.

As to this para 2(2) provides:

"This paragraph shall not apply if the property disposed of by the gift -

- (a) becomes settled property by virtue of the gift; or

(b) is a sum of money in sterling or any other currency."

[an identical exception to that found in s.38(1) FA 1957]

There are good reasons for excepting cash gifts from the substitutional provisions. Chief amongst these is the major problem likely to be encountered in tracing any cash gifted into the property substituted therefor - in particular where it is mixed with the donee's own monies. These reasons do not provide a complete answer, for para 2(3) may be thought to cast doubt on their soundness as reasons for excluding cash gifts by referring to the proceeds of sale of gifted property. In my view, however, the solution is to be found not in the uncertain legislative purpose which may be perceived behind the various provisions but in the words actually used.

The intention of para 2(2) is clear: but for para 2(1) reservations of benefits out of property substituted for the gifted property would not bring the substituted property within the ambit of s.102. Para 2(1) provides expressly for the inclusion of such substituted property. Para 2(2) expressly excepts gifts of cash. So property purchased with or substituted for the "sum of money" referred to in the provision is at no time to be treated as property comprised in the gift. That does not, of course, exonerate one from the task of determining the true nature of the gifted property. But once it is determined that the subject matter of the gift is truly a sum of cash the Revenue cannot look to the asset purchased with that cash or substituted therefor so as to bring the asset within the reservation of benefit net.

Settlements

This article has so far been concerned with gifts of cash which vest absolutely in the donee. The views expressed have no application where the cash becomes settled property as a consequence of the gift. Para 5 of Sched 20 provides rules of general application to settled property. It is immaterial for the purposes of that provision whether the property gifted comprised cash or some other asset. One has simply to look at the settled property at the "material date" (usually the death of the settlor/donor) and ascertain whether and to what extent it was derived from the settlor and whether the settlor/donor has reserved a benefit out of that property at that date. Given that trustees of settled property have a duty to exercise their powers solely for the benefit of the identified beneficiaries, it would in most cases be impossible for the settlor to reserve a benefit unless that reservation could be spelt out of the terms of the settlement itself. Furthermore, any cash gifted to or received by the trustees can be readily traced into and identified with other property comprised in the settlement. Hence there is no reason of practicality or policy which would prevent property purchased out of cash settled by the donor from becoming subject to the charge on gifts the subject of a reservation.

Gifts by Cheque

There remains one question. What is a "sum of money" for these purposes? Virtually all gifts of cash are made by cheque. In some cases they may be made by overdrawing an account. In most cases they will be made out of credit balances.

In my view it matters not whether the gift is made by overdrawing an account or out of a credit balance. Every gift by cheque will be treated as a gift of a sum of money save in the exceptional case where the payment by the donor is to a vendor or other person from whom property is to be purchased for the benefit of the donee (i.e., in the circumstances considered above). Parliament must be assumed to have regard to the realities of modern life which have been in place for well over a century: one of which is that most transactions involving substantial sums of money are made by cheque and not in currency such as bank notes or coinage. I can see no ambiguity in this expression which might be resolved by reference to the word "debt" in para 2(3)(b) so as exclude from the reference to a "sum of money" the gift of part of the amount standing to the credit of the donor at a bank which (effectively) a gift by cheque entails. Limited support for this view can be found in *Gresham Life Assurance Society Ltd v Bishop* [1902] AC 287 at 296 (Lord Lindley) and *Central Electricity Board v Halifax Corporation* [1963] AC 785 at 797 (Lord Reid).