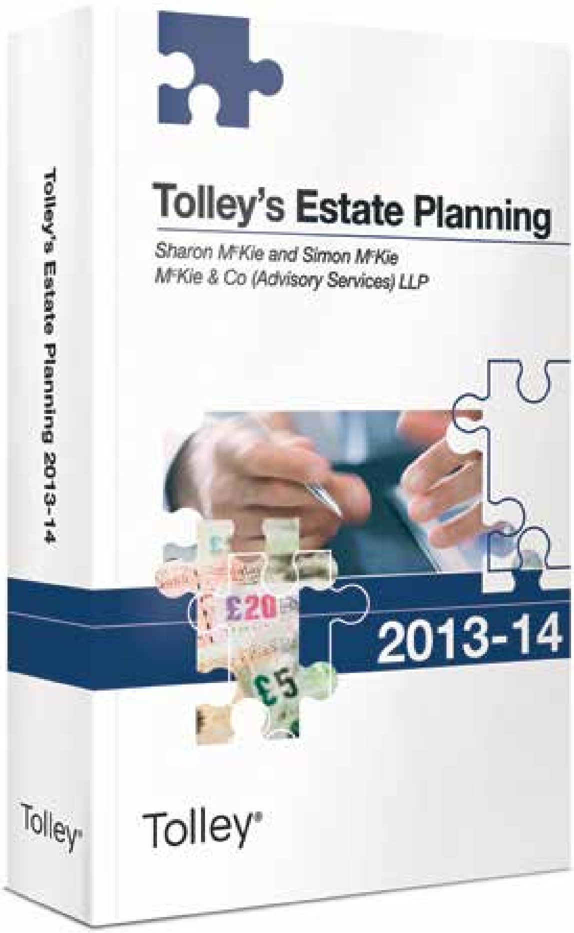
TOLLEY ESTATE PLANNING 2013

Lifetime Planning - Extract



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Chapter 2

Lifetime Planning

Introduction

[2.1] The purpose of this chapter is to give a general outline of the basic principles involved in lifetime estate planning. It will outline a number of matters which receive more detailed treatment in other chapters.

So: 'what is the primary purpose of lifetime planning?'. The traditional response will be the mitigation of inheritance tax payable on a person's death'. In today's world, however, consideration needs to be given to the mitigation of capital gains tax and, in some cases, income tax. It should be remembered that tax savings are not the only purpose of estate planning. Whilst the deceased's heirs will usually regard the inheritance tax payable on death as being most instrumental in reducing their share of the estate, the legal and other costs of winding up the estate, which these days can be considerable, have the same effect. Therefore, one aspect of lifetime planning should be to organise your estate into a form which minimises the costs of administration after death.

Whilst one motive a client may have for passing assets on to his children may be to take a proportion of his estate out of the inheritance tax charge on his death, there are other motives for doing so. These include the desire to give children a 'start in life', by helping them, for example, to buy a flat or a car or set up their own business; or the desire to help with the cost of educating their grandchildren. The client will therefore be seeking advice on the most tax efficient ways of making such gifts; in particular, ways which give rise to minimum inheritance tax, capital gains tax, stamp duty land tax or income tax liabilities.

These three aspects of lifetime planning – the general mitigation of the inheritance tax charge on death, tax efficient ways of giving and the general organisation of an estate – are the subject matter of this chapter. There is a clear overlap between the first and second of these because one of the most obvious ways of mitigating inheritance tax on death is by immediate lifetime gifts. Thus, whilst a client may have differing motives for making a gift during his lifetime, the general principles involved will be the same and accordingly the second of these three aspects will be dealt with as part of the first.

Mitigation of inheritance tax

[2.2] Broadly, inheritance tax may be mitigated in one of the following four ways.

(a) Reducing the estate through immediate lifetime gifts, the intention being to take assets out of the inheritance tax charge on death. This is known as 'asset reduction'.

(b) Reducing the estate through taking loans or otherwise incurring liabilities where the moneys borrowed or assets acquired in consideration of the liabilities are converted into relevant or excluded property or are the subject of gifts. This is known as 'liability offset'.

(c) Converting assets of the estate which do not qualify for any form of inheritance tax relief into assets which do (for example, agricultural property or business assets), the intention being to reduce the value of the assets when calculating the inheritance tax charge on death. This is known as 'asset conversion'.

(d) Freezing the value of assets in the estate so that any future growth in value will pass to the next generation, the intention being to take the 'growth element' out of the inheritance tax charge altogether. This is known as 'asset freezing'.

(e) Converting capital assets of the estate into high income producing assets. This is known as 'conversion of capital assets'.

These five methods of mitigation will need to be measured against the General Anti-Abuse Rule ('the GAAR') which is discussed in detail in **Chapter 1 What is Estate Planning?**

Each of these headings will be dealt with in turn.

Asset reduction

[2.3] Inheritance tax is a tax both on lifetime gifts and on the ultimate gift a person is deemed to make on his death. The death rates for 2013/14 are:

£0–£325,000	0%	
Above £325,000	40%	or 36% where 10% or more of the deceased's estate is left to charity (see para **2.20** below.)

These rates have been frozen until April 2018.

The rate of inheritance tax on chargeable lifetime gifts is one half of that applicable on death, ie 20% (IHTA 1984, s 7(2)). Where a person dies within three years of a chargeable gift, then the tax payable is recomputed either at the death rates in force at the date of the gift or, if the rates have been reduced, at the rates applicable at the date of death, and the additional tax, if any, becomes payable (IHTA 1984, s 7(1), (4), Sch 2). Similarly, where a person dies more than 3 years after the chargeable gift, taper relief is available. The tax is recomputed at the tapering percentages of either the death rates in force at the date of the gift or, if the rates are lower, the death rates in force at the date of death. Again, any additional tax becomes payable (IHTA 1984, s 7(4), Sch 2).

Where the subject matter of the gift:

(a) is still in the hands of the transferee or his spouse at the date of death and has a lower value at that date than at the date of the gift; or

(b) has been sold on the open market before the death at a lower value,

then the additional tax payable on death is calculated by reference to the lower value (IHTA 1984, s 131). For this to apply, however, the gift must not comprise tangible movable property which are wasting assets (IHTA 1984, s 132).

Inheritance tax is a 'cumulative' tax in the sense that all chargeable gifts made within a 7-year period are aggregated in order to determine the rates of tax applicable to the latest chargeable gift.

Potentially exempt transfers

[2.4] Potentially exempt transfers enable an individual to make specified gifts of unlimited value which will escape tax completely if he survives for a period of 7 years following the gift (IHTA 1984, s 3A). A gift will only be a potentially exempt transfer if it is made by an individual to:

(i) another individual (including the creation of a transitional serial interest); or
(ii) the trustees of a disabled trust; or
(iii) the trustees of a bereaved minor's trust on the coming to the end of an immediate post-death interest.

A gift to most forms of settlement including a gift to an interest in possession trust (unless it falls within one of the special categories) will not be a potentially exempt transfer, instead it will be a lifetime chargeable transfer. The various types of trust above are discussed in more detail in CHAPTER 4 CREATING SETTLEMENTS.

Although it is no longer possible for transfers into trust to be potentially exempt transfers, it will not necessarily be a problem for all. Where an individual is going to make a transfer equal to or below the nil rate band but considers because of family circumstances that a trust is required, there is no immediate difference between making a chargeable transfer or a potentially exempt transfer.

Example

Mary's estate is worth £2m. She is 81 years of age and wishes to settle the sum of £325,000 on interest in possession trusts for the benefit of her 4 granddaughters. Mary will be excluded from benefiting under the terms of the trust. The money was settled on 1 October 2010. Mary is 'staunch' and outlives the 7-year period.

The transfer to the trust is a chargeable transfer which is taxed at 0%. As she survived the 7-year period there is no inheritance tax liability on that transfer. Based on current law on 1 October 2017, a new full nil rate band will be available.

If she had made an absolute gift to her granddaughters, there would have been no inheritance tax paid on the gift. Having survived for the requisite 7-year period the potentially exempt transfer would be fully exempt.

> In the event that she had not survived the 7-year period the chargeable transfer would remain a chargeable transfer and the potentially exempt transfer would have become chargeable. This would have resulted in the same consequences thus reducing the nil rate band available on death.
>
> Proposals have been made in the Consultation Document 'Inheritance Tax: Simplifying Charges on Trusts – The Next Stage' which was published in May 2013 that may affect any decennial or exit charges of any further trusts Mary should wish to settle because her nil-rate band would be split between all relevant property settlements created by her.

There has been some concern as to the extent of a PET in the situation where a gift of property is made and the value of the property received by the donee is less than the reduction in value of the donor's estate. This uncertainty is caused by IHTA 1984, s 3A(2)(a), which states that a transfer of value to another individual will be a PET to the extent that the value transferred is attributable to property which becomes part of the donee's estate or, so far as that value is not attributable to such property, then to the extent that the estate of the donee has increased, and so the difference in value would be an immediately chargeable transfer. Does this have the result that the transfer of value measured as the diminution in the transferor's estate will only be a PET to the extent that the donee's estate is increased by the transfer? Clearly it does not, but a change in the wording of the HMRC Inheritance Tax Manual discussing the issue suggested that HMRC might have adopted this view. In correspondence with the ICAEW, HMRC has confirmed that it is still their view that the entire diminution in the donor's estate constitutes a PET (HMRC Inheritance Tax Manual, para 4066).

Where the transferor dies within 3 years of the gift, inheritance tax at the full death rates is charged unless those rates have increased in which case the rates at the time of the transfer are used. Where the gift is made more than 3 years before the death, the rates are 'tapered' as follows.

Years between transfer and death	*Percentage of full tax rate*
More than 3 but not more than 4	80%
More than 4 but not more than 5	60%
More than 5 but not more than 6	40%
More than 6 but not more than 7	20%

In addition, when calculating the inheritance tax payable on the transferor's estate, any potentially exempt transfers and chargeable transfers will be aggregated with the value of his estate. This may increase the amount of tax payable on death.

The potentially exempt transfer is still very important in estate planning. It is possible to make gifts without any charge to inheritance tax at all provided the transferor survives for the necessary period. The risk of the transferor dying within this period may be insured against at rates which, depending upon the age and state of health of the transferor, are often only a small percentage of the potential tax liability. This is considered in more detail in CHAPTER 7 INSURANCE.

Gifts within the nil rate tax band

[2.5] No tax is payable until the cumulative total of all gifts made within any 7-year period exceeds £325,000.

Although unlimited tax-free gifts can be made by way of potentially exempt transfers, in some circumstances it may be preferable to make gifts within the nil rate band to a discretionary trust because of the flexibility which such trusts offer. Currently, this will allow further gifts to be made to the trust, or to another trust, 7 years after the initial gift. A note of caution should be sounded because the Consultation Document 'Inheritance Tax: Simplifying Charges on Trusts – The Next Stage' published in May 2013 proposes that in calculating decennial and exit charges, an individual's nil-rate band should be split by the number of relevant property settlements which the settlor has made.

Gifts to relevant property trusts have a significant advantage over outright gifts. An election may be made under TCGA 1992, s 260 to hold-over any chargeable gain which would otherwise arise on the gift to a trust from which the settlor is excluded from benefiting, provided that there is no arrangement subsisting under which the settlor may acquire an interest in the settlement (TCGA 1992, s 169B(2)). The held-over gains may be brought back into charge if the settlor acquires an interest in the settlement or arrangements subsist under which the settlor will, or may, acquire such an interest within a defined period. The clawback period begins immediately following the disposal and ends 6 years after the end of the year of assessment in which the disposal was made (TCGA 1992, s 169C). In relation to gifts which are potentially exempt transfers, hold-over relief will only be available in relation to certain types of business assets (see **2.47** below).

Exemptions and quasi-exemptions

[2.6] Because inheritance tax is charged by reference to the reduction in value of a person's estate (IHTA 1984, s 3(1)), any gift will *prima facie* give rise to a tax charge. There are, however, a number of important exemptions and, what could be termed, 'quasi-exemptions' which enable a person to reduce his estate without giving rise to an immediate tax charge.

Some of the exemptions only apply to transactions made in a person's lifetime whilst others apply both to lifetime transfers and transfers on death. The lifetime exemptions are set out in **2.7–2.15**.

These exemptions and quasi-exemptions will now each be considered in turn.

Annual exemption

[2.7] A person may make gifts of up to £3,000 each year completely free of inheritance tax (IHTA 1984, s 19). Unlike the potentially exempt transfer, this exemption applies regardless of the nature of the recipient of the gift. In addition, there is no requirement for survival by the transferor. If this exemption is wholly or partly unused in any year, it or the balance may be carried forward to the next year. However, if it is not used in that year it will be lost.

Example

A transferor who makes a gift in year 1 of only £1,000 may make gifts within the annual exemption of up to £5,000 in year 2. If he only makes gifts of £3,000 in year 2, the £2,000 shortfall in year 1 will be lost forever.

It will be apparent that in the case of outright gifts either to an individual, or to trustees of privileged trusts, there is an overlap between this exemption and the potentially exempt transfer. Thus, a transferor who reasonably expects to survive for the next 7 years need not limit himself to annual gifts of only £3,000. He could give away significantly more each year. The existence of the annual exemption will only become material if the transferor dies within 7 years of one of these gifts.

Example

A father gives his son £49,428 in each of years 1 to 7. If the father then dies at the end of year 7, all the previous gifts will become chargeable but only as to £46,428 of each, because the annual exemption will be available to exempt the first £3,000 of each gift. As the chargeable gifts amount to £324,996, which is within the 2013/14 nil rate tax band, the lifetime gifts will not give rise to any tax charge. They will, however, be aggregated with the value of the deceased's free estate in calculating the inheritance tax due on the death.

If in the above example the father had survived for 7 years then the annual exemption is wasted on gifts that are subsequently exempt. To ensure that the annual exemption is fully utilised the father could have made a chargeable transfer before making a PET. The annual exemption is set against the first gift made. If two gifts are made on the same day, the annual exemption should be apportioned between them (see Inheritance Tax Manual, para 14143). Even with the existence of the potentially exempt transfer, the annual exemption is of importance.

The 'normal expenditure out of income' exemption

[2.8] This relief is generous in that there is no statutory limit as to the amount that can be relieved. This exemption applies to a gift if, or to the extent that, it is shown that:

(a) the gift is made as part of the normal expenditure of the transferor;
(b) taking one year with another, the gift is made out of his income; and
(c) after allowing for all other gifts or dispositions forming part of his normal expenditure, the transferor is left with sufficient income to maintain his usual standard of living. (IHTA 1984, s 21).

This exemption must be claimed and will not apply automatically. Whether a gift will qualify for this exemption will be a question of fact in each case.

Made as part of normal expenditure

[2.9] There is no statutory definition of normal. HMRC adopts the dictionary definition of normal which includes 'standard, regular, typical, habitual or usual.' According to the Revenue, 'normal' means 'normal for the transferor and not for the average person' (HMRC Inheritance Tax Manual, para 14241). So what may be 'normal expenditure' for a person with a net income of £150,000 is unlikely to be so for a person earning £30,000. On the other hand, a person who does earn £30,000 net, with no mortgage, wife, or children and a simple lifestyle may be able to make gifts, for example, to nieces and nephews, which qualify for this exemption to an extent which a person with a much higher income but with a wife and children and a high standard of living cannot.

To be normal, the gift does not necessarily have to be one of a series of regular payments but if not, it must be the type of payment which by its nature is likely to recur (as in the case of the examples given below). As it is essential that the gifts are made out of income, it is advisable that they are payments of cash.

The scope of IHTA 1984, s 21 was considered in the case of *Bennett v IRC* [1995] STC 54 (Ch D). The *Bennett* decision answered a number of key questions concerning the operation of the exemption. The term 'normal expenditure out of income' simply means expenditure which at the time it takes place accords with the settled pattern of expenditure adopted by the transferor. This pattern may be established in one of two ways, by reference to a sequence of payments by the transferor in the past, or by proof of some prior commitment or resolution adopted by him as regards future expenditure, and which he complied with thereafter.

The High Court affirmed that there is no fixed minimum period during which the expenditure must have been incurred. All that is necessary is for there to be evidence of a pattern of actual or intended regular payments, and that the payment in question falls within that category. This means that a single payment might qualify, provided sufficient resolution or commitment for future payments also exists. Where there is a commitment to make future expenditure the commitment must envisage that the payments will 'remain in place . . . for a sufficient period (barring unforeseen circumstances) . . . it need not be legally binding'. It is prudent for an individual to plan ahead. HMRC's approach is to test 'whether a gift is "normal" by considering all the relevant factors. These will include the frequency and amount, the nature of the gifts, the identity of those who received them and the reasons for the gifts' (HMRC Inheritance Tax Manual, para 14243). It is important that the pattern of such gifts is expected to continue for more than simply a *de minimis* period of time, barring unforeseen circumstances. This effectively precludes death bed schemes. The Revenue considers that a reasonable period would normally be 3 to 4 years (HMRC Inheritance Tax Manual, para 14242) despite the court ruling that there was no minimum period. In the Revenue's view, the amount of the expenditure does not have to be fixed but must be comparable in size, although small differences do not need to be queried (HMRC Inheritance Tax

Manual, para 14243). If the details provided over a given period, however, do not illustrate normality, an individual may be asked to provide particulars over a longer period. This means that gifts to a discernible class, such as members of the same family could qualify. In the case of *Nadin v IRC* [1997] STC (SCD) 107, (SpC 112) the Special Commissioners held that irregular payments to close relatives did not constitute normal expenditure.

Of course, it is more difficult to illustrate a pattern where a single gift is involved. The Revenue considers that the taxpayer must provide strong evidence in such cases that the gift was genuinely intended to be the first in a pattern and that there was 'a realistic expectation that further payments would be made'. A single gift by way of payment under a deed of covenant or other regular commitment, such as payment of the first of a series of premiums on a life policy, may be accepted as normal (HMRC Inheritance Tax Manual, para 14242).

Made out of Income

[2.10] What does the phrase 'made out of income' mean? First, it is accepted that 'income' here, means income under the general meaning of that word, that is, income determined under normal accountancy principles, rather than amounts assessable to income tax under the Taxes Acts. HMRC's guidance (at HMRC Inheritance Tax Manual, para 14250) says:

> 'Income is not defined . . . but should be determined for each year in accordance with normal accountancy rules. It is not necessarily the same as income for Income Tax purposes.'

Thus, it will not include amounts of capital such as gains arising on the surrender of life insurance policies, receipts from a discounted gift scheme or amounts paid out from a lifetime care plan. It is the Revenue's view that regular withdrawals of 5% of the premium from a single premium insurance bond are payments of capital and, as such, they do not fall within the description of income for the purposes of the IHTA 1984, s 21 exemption (HMRC Inheritance Tax Manual, para 14250).

In *McDowall (executors of McDowall, dec'd) v IRC* [2004] STC (SCD) 22, (SpC 382) the issue arose as to whether payments made by an attorney established a pattern of intended regular payments. It was held, in that particular case, that the attorney did not have the power to make the gifts. Had the gifts been valid, however, they would have been exempt under IHTA 1984, s 21.

HMRC does not consider that *McDowall* is authority that income which has not been reinvested retains its character, which is surprising considering that the Special Commissioners said: 'our inclination is to conclude that the payments were made out of retained income which remained income in character rather than capital; it was identifiably money which was essentially unspent income and which had been placed on deposit, but not invested in any more formal sense'.

HMRC will first look at the income of the year in which gifts were made to see if there was enough income available to make the gifts, before considering earlier years. With regard to income from previous years it is their view that it does not retain its character as income indefinitely. At some point it becomes capital, but there are no hard and fast rules about when this point is reached. HMRC states that: 'if there is no evidence to the contrary, we consider that income becomes capital after a period of two years . . . Each case will depend on its own facts but, in general, the longer the period of accumulation, the more likely it is that the income has become capital.' (HMRC Inheritance Tax Manual, para 14250).

The legislation recognises that income can fluctuate. IHTA 1984, s 21(1)(b) is satisfied if 'taking one year with another' the payment was made out of income. In its Inheritance Tax Manual, HMRC states that it 'may need to look at the income and expenditure over a number of years to see if the income test is satisfied.' It does warn that 'although income can be carried over from year to year in these circumstances, you should refer to Technical if the taxpayer wishes to carry forward more than two year's income' (HMRC Inheritance Tax Manual, para 14250).

Does the requirement that the transfer be 'made out of the [transferor's] income' require one to undertake a tracing exercise such as is required to determine whether there has been a remittance of foreign income or capital gains under the remittance basis? The decided cases do not specifically deal with the problem.

A counsel of perfection would be to segregate funds in the way in which, for example, a non-domiciliary segregates his offshore accounts so as to clearly identify the regular payments as being amounts of income. In practice, few people would care to have their use of money restricted in this way. If there is a surplus of income over revenue expenditure it is unlikely that HMRC would be successful in asserting that a gift from a bank account which, although it also contained capital, contained sufficient income to make the gift, did not come wholly within s 21(1)(b).

Sufficient income to maintain his usual standard of living

[2.11] How does one determine whether the transferor was 'left with sufficient income'? Of the three cases which have been decided on s 21, sub-section (c) was considered only in *Nadin v Inland Revenue Commissioners* [1997] STC (SCD) 107 (this was a case before the Special Commissioners which did not proceed to the High Court). In that case, in respect of certain years, the Special Commissioner found that the condition in sub-section (c) was not satisfied because the taxpayer's annual nursing home costs, personal expenditure and Income Tax exceeded her annual income. The decision does not record any argument on the construction of sub-section (c) except that the Appellant argued that capital sums on the sale of investments were income. What was not argued was whether sub-section (c) allows one to take into account the extent to which capital is available to supplement income and is actually applied to doing so.

HMRC assumes in its guidance, that the exemption will not apply to the extent that 'the transferor had to resort to capital to meet their normal living expenses' (HMRC Inheritance Tax Manual, para 14255). It is arguable, however, that if one had such a large amount of capital that, on the basis of the most conservative estimates, it would be sufficient to fund one's living expenses for one's lifetime, even a small amount of income would be sufficient to maintain one's usual standard of living. People in that position, therefore, would have sufficient income to maintain their usual standard of living even if all but a minimal part of their income were expended in making gifts.

There is no requirement that income is actually used for living expenses. A person may use their capital to meet their living expenses and use the income remaining, after making the gifts, for some other use. The transferor must be capable of maintaining their usual standard of living from their remaining income after making the gifts. This test is applied at the time of making the gift. Where payments have been made in fulfilment of an intention to make a series of payments out of income, and further payments are not made because of an unforeseen change in the payer's circumstances, the exemption will still apply to the payments actually made before the change.

Compliance

[2.11A] It is advisable that all such payments are documented to provide evidence that they met the conditions of the exemption. The information retained should be the date of such a gift, the name of the transferee and the nature of his relationship with the transferor, a description of the gift (ie cash, the premia paid on an insurance policy) and the value of the gift. Schedule IHT403 to the IHT Account form IHT400 provides a useful proforma of this information. It would seem that HMRC expects an IHT form IHT100 to be delivered in the situation where an inheritance tax liability would arise should the exemption be denied, its rationale being that the exemption is available 'to the extent that it is shown' (HMRC Inheritance Tax Manual, para 10652).

Uses

[2.12] Normal expenditure out of income is an important exemption, which can be used in the following ways.

(a) Payments out of income by individuals.
Individuals with large net incomes or surplus incomes can make regular gifts out of that income free of inheritance tax to members of their families or to family trusts. In some instances this is done by way of deed of covenant but it is not necessary to do so.

(b) A parent takes out a 10-year endowment policy on his life and declares himself a bare trustee of the policy for the benefit of his children. He pays all the premiums under the policy out of his income. On the maturity of the policy the beneficiaries under the trust benefit from the proceeds. If the premiums are paid direct to the life assurance company, such payments will not be potentially exempt if the amount of the premium is not fully reflected in the increased value of the policy. Provided the parent pays the premiums out of his income, however, and is able to maintain his usual standard of living, such payments should fall within the normal expenditure out of income exemption. If an alternative investment vehicle is required, there seems no reason why the same arrangement could not be set up by means of a regular monthly savings contract with a unit trust or an investment company, the units and shares themselves being held in trust for the next generation. The disadvantage of this alternative is that it will be necessary for the trustees to make annual returns of trust income.

(c) Premiums on a life policy written in trust to fund all or part of any potential inheritance tax liability on lifetime transfers or on death.

(d) Annuities paid gratuitously by partners out of their trading profits to a retired partner or the spouse of a deceased partner.

(e) Where the nil rate band has already been utilised, payments out of income could be made to fund a discretionary trust.

It should be noted that the exemption does not apply where a policy is taken out in conjunction with the purchase of an annuity on the individual's life (IHTA 1984, s 21(2)).

Regular gifts out of income may also be made to help the transferee of an earlier chargeable gift pay the inheritance tax due where there is a facility to pay the tax by annual instalments – see **2.52** and **2.63** below.

The above examples show how this exemption can be used to pass assets down to the next generation on a regular basis whilst still preserving the £3,000 annual exemption for other gifts. Ideally, both exemptions should be used in tandem.

It should be remembered that it is HMRC's view that although a transfer qualifies for the normal expenditure out of income exemption, it can still be subject to tax as a gift with reservation (HMRC Inheritance Tax Manual, para 14231).

Small gifts

[2.13] Gifts of up to £250 can be made to any one person in any one year free of inheritance tax (IHTA 1984, s 20). This exemption cannot be used in conjunction with another exemption, eg the annual exemption. It will be lost if the total annual gifts to any one person exceed £250. The gifts must be outright and therefore cannot be made to trustees. In an estate planning context the exemption is '*de minimis*'.

Gifts in consideration of marriage or registration of a civil partnership

[2.14] Gifts below a certain value that are made 'in consideration of marriage or of the registration of a civil partnership' are exempt from inheritance tax. A gift in consideration of marriage or civil partnership is not defined in the legislation. In the case of *IRC v Rennell* [1964] AC 173, HL which was an estate duty case, the House of Lords held that a gift had to satisfy three conditions to be accepted as 'made in consideration of marriage'. The conditions are that:

- the gift must be made on the occasion of the marriage or civil partnership;
- it must be conditional on the marriage or civil partnership taking place; and
- the gift must be made by a person for the purpose of, or with a view to encouraging or facilitating, the marriage or civil partnership.

Parents may each give outright gifts in consideration of marriage or of the registration of a civil partnership of up to £5,000 to the parties to the marriage or civil partnership completely free of inheritance tax. Grandparents and great grandparents may similarly make outright gifts of up to £2,500. Other persons may make such gifts of up to £1,000 (IHTA 1984, s 22).

The exemption applies not only to outright gifts but also to gifts into a settlement. The beneficiaries of such a settlement must, however, be limited to those persons specified in IHTA 1984, s 22(4) to which special reference should be made by anyone wishing to create such a settlement. Care should therefore be taken when defining the beneficiaries of such a trust.

To ensure that the gifts are made 'in consideration of the marriage or civil partnership', they must be made either before or at the date of the marriage or civil partnership. The gifts should also be accompanied by a suitable letter evidencing the fact that the gift is conditional on the marriage or civil partnership taking place. HMRC states in its Inheritance Tax Manual at para 14201 that gifts made after the marriage or civil partnership will not qualify for the exemption unless made in the fulfilment of a binding promise before the marriage or civil partnership.

Gifts for maintenance of family

[2.15] Although not an exemption, IHTA 1984, s 11 provides that the following dispositions will not be transfers of value:

(a) a disposition by one party to a marriage or civil partnership in favour of the other party for his or her maintenance;

(b) a disposition by one party to a marriage or civil partnership in favour of a child of either party for the maintenance, education or training of the child and made up to the later of the year in which the child attains 18 or ceases full-time education or training. These provisions are important in that they exempt all expenditure by parents on the education of their children;

(c) a disposition in favour of a child who is not in the care of his parent for his maintenance, education or training and made up to the later of the year in which the child attains 18 or ceases full-time education or training. Gifts made to such a child who is over 18 are only exempt if they are made by a person in whose care the child has been for substantial periods prior to attaining 18;

(d) a disposition in favour of an illegitimate child of the transferor for his maintenance, education or training and made up to the later of the year in which he attains 18 or ceases full-time education or training; and

(e) a disposition in favour of a 'dependent relative' which constitute reasonable provision for his or her care or maintenance. Unlike the situation with a spouse or civil partner and children, the provision must be both for 'care' or 'maintenance', and it must also be reasonable. These terms are not defined in the legislation but it is the Revenue's view that 'care' 'seems to suggest the provision of services, whether privately or in an institution'. The Revenue considers that 'reasonable' is 'an amount as is reasonably necessary for the purpose of providing care and maintenance (but no more), having regard to the financial and other circumstances of the transferor and the relative and the degree of incapacity [and] infirmity of the [relative]' (HMRC Inheritance Tax Manual, para 4177). The Revenue consider that the incapacity needs to be both physical and financial (HMRC Inheritance Tax Manual, para 4179). A 'dependent relative' is defined as any relative of the transferor or of his spouse or civil partner who is incapacitated by old age or infirmity from maintaining himself; or his mother or father or his spouse's or civil partner's mother or father. By concession, a gift made by a child to his or her unmarried mother is also treated as an exempt transfer, whether or not the mother is incapacitated, provided she is genuinely financially dependent on the child (Revenue Extra-statutory Concession F12).

Traditionally, the Revenue has argued that IHTA 1984, s 11 only applied to income expenditure and did not apply to a gift of capital. In *McKelvey (personal representative of McKelvey, decd) v Revenue and Customs Comrs* [2008] STC (SCD) 944, [2008] SWTI 1752 it was held that the exemption could extend to a gift of capital in appropriate circumstances. The deceased ('D') lived with her mother ('M') who was in poor health. D had been diagnosed with cancer. She transferred two properties to M to provide for her maintenance, the intention was that the properties be sold, when necessary, to meet the costs of M's nursing care. In the meantime M had had the benefit of the rental income. The properties were not sold because of M's refusal to accept paid care. HMRC sought tax on the basis that the transfers were PETs. D's executors appealed arguing that the gifts were exempt transfers under s 11. The Special Commissioner held that the reasonableness of the provisions had to be considered in the light of the circumstances as they were reasonably believed to be at the time of the gift and not as they later turned out to be. However, the transferor's view of what was reasonable was not the standard by which the gift was to be judged. An objective standard had to be applied. The Commissioner in deciding what was reasonably required considered that 'the approach adopted in personal injury cases [was] appropriate'. Using a multiplier of 5.5 being the number of years M would on the evidence have required nursing care and an annual care cost he calculated what he considered to be reasonable. This amount was exempt under s 11 whilst the excess was subject to inheritance tax.

Because the above dispositions (a)–(e) are not transfers of value they are not taken into account even if the donor dies within seven years. It is therefore possible for a terminally ill donor with young children to make substantial transfers from his estate to provide for their maintenance, education or training tax free. This is a rare form of death bed planning.

Where a gift is made on the occasion of a divorce or annulment, 'marriage' includes a former marriage or civil partnership. Thus in the context of a divorce, this exemption covers gifts to a former spouse or civil partner.

Gifts between spouses or civil partners

Inheritance tax

[2.16] Generally, gifts between spouses or civil partners are completely exempt from inheritance tax, but there are exceptions.

Where the transferor spouse or civil partner is domiciled in the UK for inheritance tax purposes but the transferee spouse or civil partner is not, the exemption is limited to a cumulative total of the exemption limit at the time of the transfer (currently £325,000 for transfers made after 5 April 2013). Prior to that date the limit was only £55,000 (IHTA 1984, s 18). It should be noted that the transferee spouse will be treated as being deemed domiciled in a country in the UK if he or she has been resident in the UK for 17 out of the previous 20 years (IHTA 1984, s 267). Therefore if a husband wishes to make a gift to his wife who has only been resident in the UK for 16 out of the previous 20 years it may be sensible to wait depending upon the value of the gift. This does not, however, preclude the treatment of such gifts as potentially exempt transfers in appropriate cases. Where the exemption limit applies, gifts are set against it first and never fall out of account, even after seven years. This is in contrast to the potentially exempt transfer regime. Where the exemption limit has been utilised the nil rate band may be available.

Example

Tessa transferred £500,000 on 7 April 2013 to her husband, Tristram, who is non-UK domiciled. The first £325,000 is exempt and the remaining £175,000 is a potentially exempt transfer. Under the terms of Tessa's will, she leaves all her property to Tristram. Tessa dies in 2021 when Tristram is still non-UK domiciled.

Although Tessa made a gift more than seven years ago, the exemption limit has been used and is therefore not available. Her nil rate band of £325,000 is available however, as seven years have passed since the gift in 2013.

For transfers of value made after 5 April 2013, it is possible for a non-domiciled individual with a UK domiciled spouse to elect to be treated as domiciled in the UK (IHTA 1984, s 267A). This is discussed in more detail in **Chapter 19 The Internationally Mobile** at **19.8** and **19.9**.

The reservation of benefit provisions may also apply between spouses or civil partners. A gift with reservation is subject to FA 1986, s 102 unless it is an exempt transfer by virtue of s 102(5). The spouse exemption is included, but for a non-domiciled spouse it only extends to the exemption limit. Therefore not only is there a potentially exempt transfer of the excess but there may also be a reservation of benefit in that excess. The next question to ask is whether there is such a reservation of benefit. The Hansard Debates at the time of the introduction of the rules in 1986 made it clear that the original provisions did not automatically treat a gift from which a spouse or civil partner could benefit as a reservation of benefit. FA 1986, s 102A, by contrast, applies where the donor or his spouse or civil partner enjoys a significant right or interest in land. Care therefore needs to be taken if the donor makes a gift of a share in the matrimonial home. Provided the conditions in FA 1986, s 102B are satisfied, no difficulties should arise. If a gift other than of land is made, care needs to be taken to ensure that a benefit is not reserved. Therefore, when a transfer is being made to a non-domiciled spouse or civil partner, care should be taken to ensure that a benefit is not being reserved by the donor.

The spouse exemption is no longer available for lifetime gifts into a trust of which the settlor's spouse or civil partner is the life tenant.

Example

> On 12 April 2006, Tony made a gift to an interest in possession trust for the benefit of his wife, June. The gift was a lifetime chargeable transfer and the spouse exemption was not available.
>
> If the gift had been made two months earlier, the gift would have been a potentially exempt transfer on which the spouse exemption would have been available.

The exclusion of the spouse exemption from lifetime transfers to an interest in possession trust may cause some difficulties.

Before 22 March 2006, it did not matter whether a gift to a surviving spouse was of an interest in possession or an absolute interest because IHTA 1984, s 49 treated the person with an interest in possession as owning the assets in which that life interest subsisted. This is still the case for individuals becoming beneficially entitled after 21 March 2006 provided that the interest in possession for the benefit of the surviving spouse or civil partner is an immediate post-death interest as defined in IHTA 1984, s 49A. There should be scope for a surviving spouse to make potentially exempt transfers if he or she finds that the benefits conferred are in excess of her requirements. The surviving spouse could surrender her interest in whole or in part. Termination of a life tenant's immediate post-death interest will be treated as a potentially exempt transfer if the trust property is vested in an individual absolutely or if there is a gift into a disabled person's trust or if the initial trust was established under the will of a parent and the immediate post-death interest is terminated and replaced by a bereaved minor's trust. In all other circumstances, the termination will be a lifetime chargeable transfer creating a potential inheritance tax charge (IHTA 1984, s 3A).

The decision as to whether a gift by will should be absolute or limited not only involves inheritance tax considerations but often involves other considerations such as:

(a) the testator's confidence as to whether his spouse or civil partner will pass that property on to their children either by lifetime gifts or by his will;
(b) the testator's concern that his spouse or civil partner may remarry and leave property to the new spouse or the new spouse's or civil partner's family; or
(c) the testator's wish to protect a spendthrift spouse or civil partner from himself.

The spouse exemption is available to couples who are separated and living apart. This is in contrast to capital gains tax and income tax where spouses or civil partners have to be living together to benefit from any spousal benefits. The spouse exemption is not available for cohabitees. In *Holland*

(Holland's Executor) v IRC [2003] STC (SCD) 43 (SpC 350) it was held that the spouse exemption applied only to persons legally married and did not apply to a person who had lived with another person as husband and wife.

There have been attempts to extend the spouse exemption by relying on the Human Rights Act 1998, the most recent case being *Burden v United Kingdom* [2008] STC 1305, [2008] 2 FCR 244 where two sisters living together claimed that their rights under the European Convention on Human Rights had been violated by the United Kingdom's restriction of the spouse exemption. The majority of the Grand Chamber held that the applicants as cohabiting sisters could not be compared to that of a married couple or civil partners and so their case failed.

The spouse exemption was extremely important in the past in its use in equalising estates to ensure that each spouse utilised their nil rate band on death. Now, unused nil rate bands can be transferred between the estates of spouses or civil partners (IHTA 1984, s 8A). The effect of this is that when the surviving spouse or civil partner dies, the nil rate band available at their death would be increased by the proportion of the nil rate band that was not used on the death of their spouse or civil partner. This is discussed in **Chapter 16 Making a Will**.

Uses

[2.17] The rebalancing of estates should be seen as part of an overall lifetime strategy designed to enable both spouses and civil partners to have sufficient assets which they can each use to make potentially exempt transfers and gifts within the annual exemption. Spouses and civil partners should consider the balance of their estates both when acquiring new assets and when deciding out of which estate an intended gift should be made. Where one spouse or civil partner has a significantly greater life expectancy than the other, then there is much to be said for keeping the bulk of their assets in the estate of the first spouse or civil partner to allow potentially exempt transfers to be made. On the other hand, any assets showing large unrealised gains should perhaps be kept in the estate of the other spouse or civil partner to get the benefit of the capital gains tax free base uplift on his or her death.

In addition, the rebalancing of assets between the spouses or civil partners may also result in capital gains tax savings. This may also confer income tax advantages but one needs to take account of the possibility that legislation might be introduced which negates any income tax savings (see **2.19** below).

Another use of the spouse or civil partner exemption is to enable assets to be given by one spouse or civil partner to the other so that the other spouse or civil partner may then give away the assets and thereby use his or her annual exemption or make potentially exempt transfers (on the basis that he or she may be the more likely of the two to survive for the necessary seven-year period). The danger of this type of 'channelling' exercise is that the Revenue may attempt to apply the 'associated operations' provisions contained in IHTA 1984, s 268 and tax the gift as if it had been made directly to the ultimate transferee by the first spouse or civil partner. The Revenue indicated, however, that it would not regard the provisions as applicable unless in such circumstances it was a condition that the second gift was made (Revenue Press

Release dated 8 April 1975), a practice which is still adopted. Care should be taken over the timing of the gifts and the evidencing of them. Where, however, the transfer between spouses or civil partners is part of a more complex series of transactions whereby one of them makes a disposition to a third party, HMRC may consider the associated operation rules. (HMRC Inheritance Tax Manual, para 14833). One also needs to consider the application of the General Anti-Abuse Rule to such transactions.

Capital gains tax

[2.18] A husband and wife and civil partners are connected persons for capital gains tax purposes (TCGA 1992, s 286) and so a disposal of assets between them would be deemed to be a disposal for a consideration equal to the market value of the assets at the date of the disposal (TCGA 1992, s 17). However, where the couple are living together the consideration is deemed to be for such consideration as gives rise neither to a gain nor a loss (TCGA 1992, s 58). This effectively means that the donee inherits the donor's base cost of the asset.

Income tax

[2.19] The settlements legislation found in ITTOIA 2005, ss 624–628 provides that where during the life of a settlor any property subject to a settlement, or any derived property, can become payable to, or applicable for the benefit of, the settlor, or spouse or civil partner of the settlor in any circumstances whatsoever, the income of the settlement is treated as the settlor's income for all income tax purposes. This is a very broad definition. It covers both payment or use of money and the provision of non-cash benefits. It is important where there are joint owners of a bank account, where one party has provided the funds, to ensure that the beneficial interest in the account is transferred and not retained by the provider of the funds. That was the position in *Bingham v Revenue and Customs Comrs* [2013] UKFTT 110 (TC), [2013] SFTD 689 where the court held that the settlement provisions applied and the entire income was assessable on the settlor. There are a number of exemptions to the settlement provisions including a spouse exemption (ITTOIA 2005, ss 625–626).

For the spouse exemption to apply there must be an outright gift. Section 626(4) provides that a gift is not an outright gift if it is conditional or there are any circumstances in which the property or related property is:

(i) payable to the giver;
(ii) applicable for the benefit of the giver; or
(iii) will, or may become, so payable or applicable.

(ii) and (iii) are not defined.

Therefore, if school fees are paid by one spouse using money arising under a settlement where both parents are liable to pay, then property will be being applied for the benefit of the settlor spouse and the gift is not an outright gift. It is therefore important that evidence is kept as to the application of the funds in the event that HMRC raise an enquiry. Although a full discussion of this subject is beyond the scope of this work, set out below are the main considerations which should be borne in mind when considering the transfer of assets between spouses.

The Revenue's interest in applying the settlements provisions was prompted by what it perceived as the use of small companies and partnerships to divert income earned by one spouse to the other. In *Jones v Garnett (Inspector of Taxes)* [2007] UKHL 35, [2007] 4 All ER 857, [2007] 1 WLR 2030, the House of Lords held that the arrangement entered into by Mr and Mrs Jones constituted a statutory settlement within the meaning of ITTOIA 2005, s 620 and therefore Mr Jones was subject to charge under s 625. However, it was held that Mr Jones's transfer to his wife was an outright gift and the spouse exemption in ITTOIA 2005, s 626 applied. Mr Jones was therefore not assessable on the dividends received by his wife. In the case of *Buck v Revenue and Customs Comrs* [2009] STC (SCD) 6 Mr Buck held all but one share in his company with his wife holding the remaining share. Mr Buck waived his entitlement to the declared dividends, with the effect that Mrs Buck received all the dividends. It was held by the Special Commissioner that the settlement provisions applied and there was no outright gift in the broad sense of that word suggested by the House of Lords in *Jones v Garnett*. There was merely a one-off dividend waiver. In *Patmore v Revenue & Customs Commissioners* [2010] TC 619 Mr and Mrs Patmore purchased company shares funded by a mortgage on a jointly owned property. New shares were created so that Mr Patmore held 98% of the 'A' shares and his wife held 2%. Subsequently, 'B' shares were issued to Mrs Patmore on which dividends were paid. The dividend income was used to repay the loans. The Revenue argued that the settlement provisions applied. Interestingly, the judge raised a point which had not been advanced by the parties in argument and on which the case was finally decided. The judge held there was no element of bounty by Mr Patmore or any intention on Mrs Patmore's part to make a gift to her husband of her fair share of the company. The judge found that Mrs Patmore had not received sufficient shares for her 50% shareholding and that there was a constructive trust in favour of Mrs Patmore. Although this decision has been criticised by commentators, it does reinforce the view expressed by the House of Lords in *Jones v Garnett*.

To avoid the ambit of ITTOIA 2005, s 624 as explained by the House of Lords in *Jones v Garnett*, it is essential that either the lower-income spouse acquired their shares by way of subscription from their own resources or they acquired the shares by an 'outright gift' from their spouse. ITTOIA 2005, s 626(4)(b) defines when a gift is not an outright gift.

In *Jones v Garnett*, although the dividends were paid into a joint bank account, no evidence was put before the Special Commissioners as to whether the property or any derived property was applied for the benefit of Mr Jones. The result may have been different if such evidence had been presented. The problem is being able to show that, within a typical marriage, moneys received by each spouse are applied for the personal benefit of that spouse. There is some evidence that HMRC are enquiring into the application of the funds received: are the moneys received applied for the personal benefit of that spouse. Within a marriage it may be difficult to provide such evidence when a joint bank account is used. Taxpayers should, therefore, be careful to retain evidence of the application of funds.

Although the application of the settlements legislation is of primary importance for income tax planning between members of married couples, it should be borne in mind that transfers of interests in small family companies as between spouses, for the purposes of capital tax planning, may bring these provisions into effect.

Income splitting is still worth exploring where there is a spouse with little significant income of his or her own, particularly where one spouse is paying the 45% additional rate of income tax. Careful planning is, however, a pre-requisite taking into consideration the application of the GAAR.

For the purposes of the charge to income tax by reference to enjoyment of property previously owned (also referred to as tax on pre-owned assets), gifts between spouses or civil partners are excluded transactions (FA 2004, Sch 15, para 10(1)(b)). This is an important exemption as spouses or civil partners may continue to make gifts to one another without triggering an income tax charge under these provisions. This charge to income tax is discussed in greater detail at **2.33** below.

Gifts to charities

[2.20] The making of gifts to charities may perhaps not be regarded as an aspect of estate planning by some, although such gifts will clearly reduce the amount of inheritance tax payable on a person's death. As many wealthy individuals feel a moral obligation to pass some of the benefit of their good fortune and hard work to those less favoured than themselves, the subject is properly within the scope of this book. Immediate, unconditional and indefeasible gifts to charities are completely free of inheritance tax (IHTA 1984, s 23). In addition, a reduced rate of inheritance tax (36%) will apply to those estates where a charitable legacy of 10% or more of an individual's estate is made. Income tax relief is available for single gifts made by individuals to charities. As charities may realise chargeable gains free of tax (TCGA 1992, s 256), a transferor proposing to give a capital sum to a charity should consider transferring investments or property which show large unrealised gains rather than cash. The gift of the investments or the property will not give rise to a charge to capital gains tax (TCGA 1992, s 257). The value of listed shares, securities, certain collective investments and qualifying interests in land given to charities will be deductible from the transferor's income for income tax purposes (ITA 2007, ss 431–446). These reliefs, with some further restrictions, also apply to gifts to Community Amateur Sports Clubs.

Charities generally and Community Amateur Sports Clubs are dealt with in more detail in **Chapter 13 Gifts to Charities and Other Non-Profit Organisations**.

Gifts of 'excluded property'

[2.21] For the purposes of inheritance tax no account is taken of 'excluded property' which ceases to form part of a person's estate (IHTA 1984, s 3(2)). Thus, gifts of excluded property may be made completely free of inheritance tax.

Excluded property appears mainly in two situations. The first is in connection with property owned by, or settled in trust by, a person who is neither domiciled in the UK nor treated as being so domiciled for inheritance tax purposes at the time the settlement was made (IHTA 1984, ss 6 and 48(3)). This situation is considered further in CHAPTER 19 THE INTERNATIONALLY MOBILE and CHAPTER 20 THE OVERSEAS CLIENT.

The other situation is that of settlements and settled property. Broadly, a 'reversionary interest' is excluded property unless:

(i) it has been acquired for a consideration in money or money's worth;
(ii) it is one to which the settlor of the settlement or his spouse or civil partner is or has been beneficially entitled; or
(iii) it satisfies certain conditions of IHTA 1984, s 74A(1), is a reversionary interest and the individual has or is able to acquire another interest in the settled property (IHTA 1984, s 48(1)(d)).

Example

Matilda is 87 years of age. The Baxter Settlement provides that she is entitled to the income of the settlement for her lifetime with the remainder to be divided between her two children Milly and Molly who have children of their own. Milly and Molly's interests are reversionary interests. As they are both financially secure they consider assigning their interests in remainder to their children. During Matilda's lifetime they are able to assign or re-settle their interests for the benefit of their children without incurring any inheritance tax charge.

This is considered in more detail in CHAPTER 5 EXISTING SETTLEMENTS.

The type of settlement under which there is a life tenant with one or more remaindermen often arises under wills drawn up in estate duty days when an exemption applied on the death of a surviving spouse, where that spouse had been left a life interest in the estate of the deceased. In the case of property settled in this way by a person dying before 13 November 1974, the exemption continues to apply on the death of the surviving spouse or on any prior termination of the life interest (IHTA 1984, Sch 6 para 2).

This type of settlement can also arise from the current intestacy rules where the deceased dies intestate leaving a spouse or civil partner and children: the spouse or civil partner will take absolutely the deceased's personal chattels and the first £250,000 and a life interest in one half of the residue of the deceased's estate with the children taking the interests in remainder on the statutory trusts (Administration of Estates Act 1925, s 46). When, however, the Inheritance and Trustees' Powers Act (which at the time of writing, had had its first reading in the House of Lords) is enacted, no such settlements will arise because the surviving spouse or civil partners will receive half of the residue absolutely.

Gifts with reservation

General

[2.22] Having looked at the most important exemptions and quasi-exemptions from inheritance tax, and before dealing with some of the practical aspects of giving, consideration must first be given to the gifts with reservation rules contained in FA 1986, ss 102–102C and Sch 20. These rules are designed to prevent an individual giving away an asset whilst continuing to enjoy the benefit from it.

The legislation provides that a gift of property subject to a reservation is treated, so far as the donor is concerned, as a partial nullity for inheritance tax purposes. This is achieved by deeming the relevant property still to form part of the donor's estate on death. The rules apply where either:

(a) possession and enjoyment of the property is not *bona fide* assumed by the donee at least 7 years before the donor's death; or
(b) the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise (or by virtue of any associated operations within the meaning of IHTA 1984, s 268) at any time within 7 years of the donor's death.

In essence, this means that a gift of property may fall foul of these provisions if the donor receives, or is capable of receiving, any direct or indirect benefit whatsoever which is in some way referable to the gift. The benefit does not have to be provided out of the donated property (*A-G v Worrall* [1895] 1 QB 99), nor does it have to be provided by the donee. The benefit may be financial, such as an annuity (*A-G v Worrall*), a rent charge (*Grey (Earl) v A-G* [1900] AC 124, [1900–1903] All ER Rep 268), a right to remuneration (*Oakes v Comr of Stamp Duties of New South Wales* [1954] AC 57) or a covenant to pay an amount equal to the amount of the service charge payable under a headlease (*Buzzoni v Revenue & Customs Commissioners* [2013] STC 262). Equally, it may well be the right to use or occupy (even as a bare licensee), or the ability to use or occupy, the donated property (*Chick v Stamp Duties Comr of New South Wales* [1958] AC 435, [1958] All ER 623, PC).

There is a wealth of complicated and contradictory case law on the meaning of the original provisions contained in the estate duty legislation. Whilst the current provisions are closely based on earlier estate duty sections, it should be remembered that inheritance tax is fundamentally different from estate duty so that old cases should be considered with a degree of circumspection. In the case of *Melville v IRC* [2000] STC 628, 74 TC 372 (Ch D) Lightman J in the High Court said at page 636:

> ' . . . I do not think that authorities on the estate duty legislation are helpful on the quite different legislation which replaced it.'

Although that may be true of the relationship of estate duty and inheritance tax generally, it does not indicate that one cannot refer to estate duty cases on reservation of benefit where the old and new legislation have substantially similar wording.

It is beyond the scope of this book to provide a detailed analysis of the complexities of the current provisions and of the old case law. The following comments are, however, offered as a guide. It is paradoxical really that nearly 30 years after the introduction of inheritance tax, including the reservation of benefit provisions, very few cases have considered these provisions.

Property given away

[2.23] In determining whether there has been any reservation of benefit, it is essential to first identify the property which has been given away by the donor (see for example, *Munro v Comr of Stamp Duties of New South Wales* [1934] AC 61 (PC) and *St Aubyn v A-G (No 2)* [1952] AC 15, [1951] 2 All ER 473 (HL)). It is this property which the donor has to continue to either possess or enjoy. Property in which the donor retains no interest and does not possess or enjoy will not be subject to a reservation. A gift made to a spouse or civil partner after 19 June 2003 will be a gift with reservation where:

- the property becomes settled property by virtue of the gift;
- the trusts of the settlement give an interest in possession to the donor's spouse or civil partner (who is defined as the 'relevant beneficiary'), so that the gift is exempt from inheritance tax by reason of the spouse or civil partner exemption and the rule which treats an interest in possession as equivalent to outright ownership (IHTA 1984, s 49(1));
- between the date of the gift and the donor's death the interest in possession comes to an end; and
- when that interest in possession comes to an end, the donor's spouse or civil partner does not become beneficially entitled to the settled property or to another interest in possession in it (FA 1986, s 102(5A)).

In applying s 102 in such circumstances, the original disposal by way of gift will be treated, where relevant, as having been made immediately after the beneficiary's interest in possession ends, so that the circumstances before that time will not be considered in determining whether the property given away is 'property subject to a reservation' for inheritance tax purposes. This followed the Court of Appeal's decision in *IRC v Eversden (Greenstock's Executors)* [2003] EWCA Civ 668, [2003] STC 822. These provisions are likely to be relevant only to trusts established before 22 March 2006 because for trusts made on or after that date the spouse or civil partner exemption is unlikely to be available because s 49 only applies to a very limited range of interest in possessions created *inter vivos*.

This concept of first carving out a separate proprietary interest from an asset to be given away and then giving away the remaining interest (often called 'shearing') was accepted practice in estate duty days and the Revenue appear to accept its efficacy under the inheritance tax regime, subject to certain important qualifications.

A particular application of the shearing principle was the lease carve out scheme. This was commonly used by estate planners in relation to the family home. The House of Lords considered the scheme and found in favour of the taxpayer in *Ingram v IRC* [2000] 1 AC 293, [1999] STC 37 (HL). It was that case that led to the reservation of benefit provisions being extended to certain gifts of interests in land where the donor continues to occupy, or enjoy some right in, the land after the gift (FA 1986, ss 102A, 102C). This is examined in more detail in CHAPTER 9 THE FAMILY HOME AND OTHER RESIDENTIAL PROPERTY at **9.17–9.19**.

The shearing technique is of wider application than the family home and remains important in relation to estate planning.

Reservation

[2.24] The provisions only catch benefits reserved to the donor and not those reserved to his or her spouse or civil partner whereas the estate duty provisions caught both. Whilst this does give some scope for flexibility in estate planning – for example, the donor's spouse or civil partner could be a discretionary beneficiary of a trust while the donor may not be – great care must be taken to ensure that any benefit reserved to a spouse or civil partner cannot be treated as a benefit to the donor including a benefit obtained by virtue of any associated operations (FA 1986, Sch 20 para 6(1)(c)). Thus, for example, a wife who receives a distribution of capital from a discretionary trust of which her husband was the settlor should not pay the money into a joint bank account or one on which her husband has drawing facilities. Nor should she use the money to maintain him or to discharge any liabilities which would normally be regarded as his responsibility. It should also be borne in mind that the inclusion of the settlor's spouse or civil partner as a beneficiary under a trust can have adverse income tax and capital gains tax consequences for the settlor.

Possession and enjoyment

[2.25] Where possession and enjoyment is not bona fide assumed by the donee at or before the beginning of a relevant period or at any time in the relevant period the property is not enjoyed to the entire exclusion or virtually to the entire exclusion of the donor and of any benefit to him by contract or otherwise, a benefit will have been reserved.

The gifts with reservation provisions do not apply where the donor and 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 (FA 1986, s 102B(4)). The donee must not pay more than his or her share of the outgoings. There is not, however, a requirement for the proportionate sharing of expenses. It would cover the situation where elderly parents make unconditional gifts of a share in their house to their children and the property is occupied by the parents and their children each bearing his or her pro rata share of the running costs. This is not a gift with reservation because the children have taken up occupation and the parents' occupation is referable to their joint ownership and not the gift. (HMRC Inheritance Tax Manual, para 14332). The scope for this type of arrangement is fairly limited and problems may arise if one or more of the children leave home but retain their interest.

It is unwise to assume, relying on the authority of *A-G v Seccombe* [1911] 2 KB 688, that the words 'by contract or otherwise' in FA 1986, s 102 will be construed in accordance with the '*ejusdem generis*' rule. It was categorically stated by the government spokesman in the Standing Committee G debates on the 1986 Finance Bill that the non-enforceable enjoyment or benefit of property is sufficient to bring the gifts with reservation provisions into play.

Continuation of reasonable commercial arrangements

[2.26] A director or employee of a company who wishes to give away some or all of his shares in the company should beware of reserving a benefit. The continuation of reasonable commercial arrangements in the form of remuneration or other benefits for the donor's services in the company entered into before the gift will not be considered by the Revenue to be a reservation of benefit provided the benefits were in no way linked to or affected by the gift (HMRC Inheritance Tax Manual, paras 14337 and 14395). What is reasonable will depend upon all the facts. Generally speaking, it will be determined by what might be reasonably expected under arm's length arrangements between unconnected persons (HMRC Inheritance Tax Manual, para 14337). However, if the donor attempts to entrench his position and benefits, eg by way of a fixed term service contract, or if following the gift he receives remuneration or other benefits in excess of normal commercial rates, he will be running the risk of reserving a benefit.

If the donor is the sole trustee, or one of the trustees, of the donated property, his interest as trustee will not amount to a reservation of a benefit. This was the position under the estate duty legislation (*Comr of Stamp Duties of New South Wales v Perpetual Trustee Co Ltd* [1943] AC 425 (PC)). The Revenue has confirmed that in its view, the donor or his spouse or civil partner being a trustee of a settlement does not of itself give rise to a reservation of benefit (HMRC Inheritance Tax Manual, para 14394). The position is the same even if the donor and spouse are entitled to payment for their services as trustees provided the remuneration is not excessive. This is despite the decision in the *Oakes* case.

Simply because a settlor is a trustee of a settlement established in favour of his or her minor children should not itself cause a reservation to arise. Yet where such settled funds are subsequently applied to meet a contractual liability of the parent which was incurred to maintain his children, a reservation would then arise.

The position is more complex in the case of a settlor who acts as trustee of shares in a company of which he or she is a director. Specific relieving provisions are generally required in the trust instrument if the trustee is to retain the remuneration received from that company, unless a timely application is made to the court for relief (*Re Keeler's Settlement Trust, Keeler v Gledhill* [1981] 1 Ch 156, [1981] 1 All ER 888). In this type of situation, the Revenue accepts that the continuation of reasonable commercial arrangements governing remuneration and benefits entered into prior to the gift would not, by itself, amount to a reservation (HMRC Inheritance Tax Manual, para 14395). This assumes that the remuneration package was not linked to, or affected by, the gift. However, it is suggested by some commentators that the donor should enter into a legally binding long-term service agreement prior to settling the shares, whilst having due regard to company law considerations; the idea being for the donor to 'carve out' rights in his favour, excluding those from the property gifted. Doubts have been expressed concerning this suggestion. The argument being that the associated operations provisions contained in FA 1986, Sch 20 para 6(1)(c) might be applied to link the contractual arrangements with the subsequent gift of shares.

As a result it may be generally prudent to dissuade an executive director from being a trustee when settling shares in his or her private company. As such settlors are often reluctant to relinquish control in this way it will be necessary to arrange matters within the published parameters. A further precaution might be for the donor to enter into a suitable long-term service agreement prior to giving the shares away, albeit that doubts may exist over the degree of protection this will afford.

Exclusion or virtual exclusion

[2.27] HMRC accept that the word 'virtually' in FA 1986, s 102(1)(b) is not defined but considers that it means 'to all intents' or 'as good as'. It interprets 'virtually to the entire exclusion' as covering cases in which 'the benefit obtained by the donor is insignificant in relation to the gifted property' (HMRC Inheritance Tax Manual, para 14333).

The Revenue outlines a number of situations where limited benefits could arise to a donor without causing the reservation of benefit rules to come into play (HMRC Inheritance Tax Manual, para 14333). These are set out below:

(a) A house which becomes the donee's residence but where the donor subsequently stays, in the absence of the donee, for not more than two weeks each year, or stays with the donee for less than one month a year.
(b) Social visits, excluding overnight stays made by a donor as a guest of the donee, to a house which he had given away. The extent of the social visits should be no greater than the visits which the donor might be expected to make to the donee's house in the absence of any gift by the donor.
(c) A temporary stay for some short-term purpose in a house the donor had previously given away; for example, while the donor convalesces after medical treatment or looks after a donee convalescing after medical treatment or while the donor's own home is being redecorated.
(d) Visits to a house for domestic reasons; for example, baby-sitting by the donor for the donee's children.
(e) A house together with a library of books which the donor visits less than five times in any year to consult or borrow a book.
(f) A motor car which the donee uses to give occasional (ie less than three times a month) lifts to the donor.
(g) Land which the donor uses to walk his dogs or for horseriding provided this does not restrict the donee's use of the land.

The following are suggested by HMRC as representing cases where the reservation rules are likely to apply:

(i) A house in which the donor stays most weekends, or for a month or more each year.
(ii) A second home or holiday home which both the donor and the donee use on an occasional basis.
(iii) A house with a library in which the donor continues to keep his own books, or which the donor uses on a regular basis; for example, because it is necessary for his work (HMRC Inheritance Tax Manual, para 14333).
(iv) A motor car which the donee uses every day to take the donor to work.

Gift exemption

[2.28] Gifts which qualify for certain inheritance tax exemptions – in particular the exemption for gifts in consideration of marriage or civil partnership – cannot constitute a gift with reservation (FA 1986, s 102(5)). Gifts to charities or registered clubs are also outside their scope but this is not surprising as the charity/registered clubs exemption contains its own reservation of benefit provisions in IHTA 1984, s 23(4). Potentially exempt transfers and gifts within the annual exemption or normal expenditure out of income can, however, be caught by the provisions.

Full consideration exemption

[2.29] The underlying principle is that the reservation rules will not apply where an interest is given away and the donor pays full consideration for the future use of the property.

Where a donor gives full consideration, the retention or assumption by him of the actual occupation or enjoyment of land, or of a right over land, or the actual possession of a chattel, is to be disregarded in determining whether the property is enjoyed to his exclusion or virtual exclusion and of any benefit to him by contract or otherwise. What constitutes full consideration has always been of concern for those involved in estate planning because, taken literally, the failure to satisfy this requirement by however small a margin would be fatal. The Revenue's interpretation of full consideration in this context is given in the Revenue Interpretation 55:

> 'While we take the view that such full consideration is required throughout the relevant period – and therefore consider that the rent paid should be reviewed at appropriate intervals to reflect market changes – we do recognise that there is no single value at which consideration can be fixed as 'full'. Rather, we accept that what constitutes full consideration in any case lies within a range of values reflecting normal valuation tolerances, and that any amount within that range, can be accepted as satisfying the para 6(1)(a) test.'

A difficulty arises in relation to establishing a rental value for assets where there is no meaningful rental market. The Revenue states that 'it is unlikely that any . . . arrangement could be overturned if the taxpayer can demonstrate that it resulted from a bargain negotiated at arms' length by parties who were independently advised and which followed the normal commercial criteria in force at the time it was negotiated' (HMRC Inheritance Tax Manual, para 14341). In relation to items such as country house chattels or valuable works of art where there may be no meaningful rental market the Revenue's accepted norm is 1% of capital value. It admits that this rate 'has no robust basis but is regularly accepted by HMRC on a without prejudice basis' (Chattels Valuations Fiscal Forum – see STEP Journal April 2007). The Revenue has warned that where purely nominal rental rates are used taxpayers 'can expect them to be vigorously challenged'. With regard to chattels, the procedure in the Bills of Sale Acts should be followed.

Infirm relative exemption

[2.30] There is an exemption of limited application which, broadly speaking, will cover the case where a donor gives a house to a relative whose circumstances have changed since the original gift and who has become unable to maintain himself for reasons of old age or infirmity. This only applies if the donee is a relative of the donor or of the donor's spouse or civil partner.

Interest in possession trusts

[2.31] FA 1986, s 102ZA subjects the exercise of the trustees' discretion to terminate an interest in possession to the reservation of benefit rules. Where the section applies, an individual is treated as having disposed of, by way of gift, property in which his interest in possession has come to an end. The section applies where an individual became beneficially entitled to the interest in possession before 22 March 2006 or did so after that date where the interest is an immediate post-death interest, a disabled person's trust, a transitional serial interest or a IHTA 1984, Sch 5(IB) interest and the interest in possession comes to an end during the individual's lifetime. This section seems to have been introduced to prevent the re-organisation of trust interests resulting in passing interests to children without incurring tax charges, although HMRC claims it was to 'align the treatment of cases involving trust property formerly subject to an interest in possession . . . with the treatment of similar facts where the property was formerly owned outright'.

Tracing

[2.32] FA 1986, Sch 20 contains various provisions enabling the property subject to the reservation to be 'traced' into other property. These provisions are necessary in order to ascertain the value and nature of the property which is to be treated as forming part of the donor's estate immediately before his death. Where the original gift, however, is one of cash (and the gift is not to a settlement), it is arguable that the tracing provisions do not apply. This will effectively freeze the value of the property subject to the reservation, but in addition it raises the interesting argument, that if by the time of the death of the donor, the cash has ceased to exist, then there will be nothing on which FA 1986, s 102 can bite. Thus, for example, if a donor gives his son a cash gift and the son subsequently uses the money to buy a property which the donor occupies until his death, it might be thought that there is a reservation of benefit by associated operations to the donor (by virtue of his occupation of the property provided by his son). The Revenue considers this to be the case. One argument, however, is that as the cash ceases to exist as from the date of the purchase of the property, and because there are no provisions tracing the cash into the property, it is difficult to see how there can be any property subject to a reservation at the donor's death. The contrary argument is that by being expended the cash does not cease to exist but merely becomes the property of another (and so on *ad infinitum*) so that the property subject to the reservation continues to exist (although not in the hands of the donee) until the donor's death. Until such time as this matter is tested in the courts the uncertainty will remain. In any event, this kind of arrangement will be subject to an income tax charge on pre-owned assets which is discussed in greater detail in **2.33** below.

Effect of rules

[2.32A] The effects of the gift with reservation provisions are far reaching. In the event of these provisions being of relevance when advising a client, one should consider whether the client is making a gift of the right property. One has to consider the wasted time and costs of not only implementing the transaction but any subsequent correspondence with the Revenue together with the uncertainty for the client as to whether he has a potential inheritance tax charge. If the reservation of benefit provisions are found to apply, the donor will have to pay the inheritance tax on his death as if he still owned the property but will not benefit from any capital gains tax market value uplift on death.

The pre-owned assets charge

General

[2.33] The pre-owned asset charge is not a charge to inheritance tax but a charge to income tax.

A charge is imposed where assets have, broadly speaking, been given away by an individual but under such circumstances that the individual has retained the right to use or enjoy the assets given away while circumventing the inheritance tax gift with reservation rules (see **2.22** above). Much capital tax planning has been designed to create situations which do not fall within the gifts with reservation rules. In the examples used in this section, for the sake of simplicity, it is assumed that the gifts with reservation rules have been circumvented unless otherwise stated.

The pre-owned assets provisions may be very unfortunate for those individuals who have owned assets which have been disposed of, in whole or in part, since 18 March 1986. Although an election to opt out of the pre-owned asset provisions is possible (see **2.45** below), such an election still does not put an individual who has undertaken tax planning in the same position as he would have been if the planning had never been implemented. It may be expensive to unwind the structures already put in place. In some cases, it may not be possible to do so at all or to do so only by incurring a further tax charge.

The legislation relating to the pre-owned asset charge can be found in FA 2004, s 84 and Sch 15. Guidance has been published by HMRC which can now be found at para 44000 onwards of the Inheritance Tax Manual.

There are three separate charges under the pre-owned assets charge as the legislation differentiates between land, chattels and intangible property in a settlor-interested settlement.

Land

[2.34] Under FA 2004, Sch 15, para 3, an income tax charge will arise where an individual (the chargeable person) occupies land (referred to as the 'relevant land'), whether alone or with other persons, and the 'disposal condition' or the 'contribution condition' is satisfied in relation to the land.

(i) Occupation

Occupation is not defined in the legislation and so one would apply its normal meaning, that of 'taking possession'. The Revenue states that 'the meaning . . . should be taken quite widely' (HMRC Inheritance Tax Manual, para 44003). Occupation is distinguished from residence as residence 'implies a greater level of permanence so a lower threshold is required to satisfy the occupation condition'. HMRC states that a visitor may not be in occupation but someone who has a key who can freely enter and leave premises 'is more likely to be in occupation; even if they are absent for significant periods'. A person storing possessions in a property may be regarded by HMRC as occupying a property but only if they had a right of access to use the property as they wished, or were the only person with the means of access. Storing possessions on its own is not occupation but it may be evidence of occupation.

HMRC does not regard a person as occupying a property from which he receives rent from the actual occupier (HMRC Inheritance Tax Manual, para 44003). This is significant in considering the scope of the exemption in FA 1986, s 102B(3)(a) from the reservation of benefit charge. The Revenue says that, where occupation or use is limited in nature or duration, it may not fall within FA 2004, Sch 15, para 3; each case will depend on its own facts. There is no provision providing exemption from charge where the taxpayer's occupation is limited. What the Revenue probably means is that limited periods of physical presence or limited usage will not amount to occupation. The Revenue will apply its interpretation of occupation found in RI 55 (in the context of the gifts with reservation) to the pre-owned assets regime. Be that as it may, the Revenue gives a number of examples of what it calls limited occupation which will not fall within FA 2004, Sch 15, para 3. One such example is a house which is the owner's residence but where the chargeable person, subsequently to the gift, stays in the house with the other person for less than 1 month each year or, in their absence, stays for not more than 2 weeks each year. (HMRC Inheritance Tax Manual, paras 14333 and 44003).

Further examples have been provided by the professional bodies on which the Revenue has commented. The Revenue has confirmed that where an individual has a right to the property throughout the year but does not in fact use it 'it is unlikely that there would be a Schedule 15 charge'. The Revenue has declined to confirm that no charge would arise where there is a right to use the property throughout the year and the chargeable person uses the property but it falls within the *de minimis* limit set out in the guidance notes that there would be no charge. Where there is a right to use the property throughout the year and an individual uses the property, for example, for 3 months of the year, the charge will be based on the whole year, even where others have a right to use the property during that period. This is of particular relevance in relation to holiday homes.

Due to the lack of definition of occupation it will be necessary to judge each situation on its facts which will inevitably lead to some uncertainty for the taxpayer.

The question of 'what is occupation' was considered in the VAT case of *Principal and Fellows of Newnham College in the University of Cambridge v Revenue and Customs Comrs* [2008] UKHL 23, [2008] 2 All ER 863, [2008] STC 1225. The House of Lords held that mere physical presence on land was not enough to constitute occupation. For a person to be in occupation they should have the right to occupy the property as if they are the owner and to exclude any other person from enjoyment of such a right in addition to physical presence. Following this decision, HMRC has revised its interpretation of 'occupation' in Revenue & Customs Brief 33/09. Whilst the Revenue states the clarification relates only to the test of occupation in VATA 1994, Sch 10, paras 12–17, it may nonetheless be useful in respect of the pre-owned assets charge.

(ii) Land

An 'interest in land' has the same meaning as that found in IHTA 1984, Pt VI Ch IV where it is defined by IHTA 1984, s 190 as not including any estate, interest or right by way of mortgage or other security.

(iii) The 'disposal condition'

The 'disposal condition' is satisfied where, at any time after 17 March 1986, a chargeable person has:

- owned an interest in the relevant land (or in other property the disposal proceeds of which were directly or indirectly applied by another person towards the acquisition of an interest in the relevant land); and
- disposed of all or part of his interest in the relevant land or the other property, otherwise than by an excluded transaction (see **2.37** below).

These provisions might apply where, for example, a father gives away a property he owns to his son and, sometime later, either the father moves back into the property or the son sells the property and buys a new property which the father later occupies. They can also apply in more complex situations.

Examples

Marjorie gave her shares worth £250,000 to her great granddaughter Jasmine who sold the shares and used the proceeds to purchase a house in which Marjorie now lives.

The disposal condition would be met because Marjorie once owned other property (ie the shares) the proceeds of which were used by Jasmine to acquire the house.

If Jasmine had used the sale proceeds to build a granny annex onto the house in which Marjorie lived, it would appear that the disposal condition is not met because the sale proceeds of the shares were not used to acquire an interest in land but to improve the land.

(iv) The 'contribution condition'

The 'contribution condition' is satisfied where, at any time after 17 March 1986, the chargeable person has provided (directly or indirectly), otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of:

- an interest in the relevant land; or
- an interest in any other property, the disposal proceeds of which were (directly or indirectly) applied by another person towards acquiring the relevant land.

Examples

A father gives his son £100,000 towards the purchase of a £200,000 flat. The son provides the rest of the consideration. The father later moves into the flat.

The contribution condition is satisfied and an income tax charge arises.

Gillian gives Maxwell Court to Barbara who exchanges it for Hill House. Gillian moves into Hill House.

The contribution condition is satisfied and an income tax charge arises.

The contribution condition is extremely wide. It has been said, however, that if the chargeable person was only entitled to a share of the proceeds of the other property, then only that share of the proceeds should be regarded as flowing through to the relevant land (Finance Bill Standing Committee, 18 May 2004 col 266). It should be noted that an outright gift of money made at least 7 years before the chargeable person occupies the relevant property will be excluded (FA 2004, Sch 15, para 10(2)(c)). The Revenue does not consider that the contribution condition is satisfied where a lender resides in property purchased by another with money loaned to him by the lender. It is the Revenue's view that 'this is because the outstanding debt will form part of the lender's estate for Inheritance Tax purposes, and the lender cannot be said to have provided a contribution to the purchase of that property when that money has to be repaid to them, even if the loan was interest free.' (HMRC Inheritance Tax Manual, para 44005). It is clear, however, that the contribution condition is satisfied in these circumstances. This places a taxpayer and his adviser in a difficult position as to whether or not to rely on guidance which is incorrect in law.

A disposition which creates a new interest in land out of an existing interest in land is treated as a part disposal of the existing interest. This is, of course, of relevance to lease carve-out cases.

(v) Excluded transactions

There are five excluded transactions in relation to both the disposal condition and the contribution condition (see **2.37** ff below).

(vi) The charge

Where the provisions apply, a taxpayer is deemed to receive an amount of income equal to the chargeable amount on which he will be liable to income tax. The valuation of property follows the rule in IHTA 1984, s 160. It is the price that the property might reasonably be expected to fetch if sold in the open market at that time, without any scope for a reduction on the grounds that the whole property is to be placed on the market at one and the same time (FA 2004, Sch 15, para 15). The chargeable amount is calculated using the formula (set out in FA 2004, Sch 15, para 4) shown below:

$$R \times \frac{DV}{V}$$

where

R is the rental value of the relevant land;

DV is the appropriate proportion of the value of the relevant land at the valuation date. The definition varies according to whether it is the disposal condition or contribution condition that is at issue; and

V is the value of the relevant land at the valuation date.

Broadly speaking, the chargeable amount will be the appropriate rental value of the relevant land less any moneys actually paid to the owners of the relevant land in pursuance of a legal obligation. In respect of the taxpayer's occupation of the land, the intention is that only payments that are taxable in the hands of the recipient should be allowed as a deduction from the pre-owned assets income tax charge (Finance Bill Standing Committee, 18 May 2004 col 269). So where a person decides to pay a full market rent for occupation of the property in order to eliminate the pre-owned assets charge, he should put in place a tenancy agreement under which the rent is paid. For a taxpayer who, for example, wishes to benefit his son, such an arrangement has the additional advantage that it passes further value to the son by way of rental payments. The payment must be made during the 'taxable period' which is defined as the year of assessment, or part of the year of assessment, during which a pre-owned asset charge applies to a chargeable person (FA 2004, Sch 15 para 4(6)). Payments made outside the taxable period are disregarded.

Example

Robin gives his daughter a property but continues to stay in it when he wishes to do so with no further permission from his daughter. He actually stays at the property 12 weeks per year. Robin enters into a legal agreement to pay his daughter £200 per week for his accommodation whilst he stays with her during the year and so pays £2,400. The appropriate rental value is £5,000 and so he will pay income tax on £2,600.

The rental value is based on an annual value as defined in FA 2004, Sch 15, para 3. The annual value is the rent which might reasonably be expected to be obtained on a letting from year to year if:

- the tenant undertook to pay all taxes, rates and charges usually paid by a tenant; and
- the landlord undertook to bear the costs of the repairs and insurance and the other expenses necessary for maintaining the property in a state to command that rent (FA 2004, Sch 15, para 5).

This is a circular definition because, in order to know the rent which might reasonably be expected, one must know the repairs and other expenses that are necessary to maintain the property in a state to command that rent. In order to know the repairs that are required, one needs to know the rent. The formula could be described as a 'landlord's repairing lease' but the Treasury Notes state that the annual value is the rent which will be paid under a standard tenant's repairing lease. The sources from which the required valuation should be obtained have not been specified. The Revenue expects the chargeable person to take all reasonable steps to ascertain the valuations, as they would do, for example, if they were looking to let a property in the open market (HMRC Inheritance Tax Manual, para 44010).

Where there has been a disposal of the original property or a cash gift has been used to acquire land, the chargeable person will only be assessed to tax on the portion of the value of the relevant land which can reasonably be attributed to the value of the original property or the cash originally given. The Revenue, in their Manual, has referred only to the need to make a reasoned judgement, on the basis of the facts, and of the value of the land disposed of and its ultimate sale price, the consideration provided and the independent financial resources of the recipient (HMRC Inheritance Tax Manual, para 44013). This so-called guidance does not assist a practitioner as it says nothing of use.

Example adapting the Revenue's example

> Marjorie gave land worth £200,000 to her grandson Luke who sold it in 2003 for £500,000. He used the proceeds to buy a house for £300,000 in which his grandmother now lives.

In such a situation, the Revenue considers it reasonable to treat the whole value of a new property as attributable to the property originally disposed of. If the value of the new property exceeds the proceeds received from the sale of the original property the proportion of the value reasonably attributable to the original property would be reduced. The value reasonably attributable to the new property cannot exceed the final value of the property originally disposed of.

(vii) Sales

Where there is a sale of an entire interest in a property by the chargeable person for a consideration paid in money (sterling or other currency), other than as an excluded transaction, this is known as a 'non-exempt sale'. An example of a non-exempt sale is an outright sale of a property to a connected person at an undervalue. The legislation attempts to take account of the fact that the proceeds from the sale will be comprised in the value of the chargeable person's estate. In these circumstances the annual rent is reduced by multiplying the annual rent by the 'appropriate proportion' calculated by the following fraction:

$$\frac{MV - P}{MV}$$

where

MV is the value of the interest in land at the time of sale; and

P is the amount paid

Example

Barbara sold 50 acres of land (worth £2,000,000) to Gillian for £1,600,000. The rental value was £100,000.

The appropriate proportion is

$$\frac{£\,2{,}000{,}000 - £\,1{,}600{,}000}{£\,2{,}000{,}000} = \frac{£\,400{,}000}{£\,2{,}000{,}000} = \frac{1}{5}$$

The rental value is then multiplied by the appropriate proportion

$$\frac{1}{5} \times £\,100{,}000 = £\,20{,}000$$

In this way, the amount for the annual rent which is attributable to the sum paid to the chargeable person for his interest is removed from charge.

Chattels

General

[2.35] An income tax charge will arise under FA 2004, Sch 15 para 6 where a chargeable person is in possession of, or has the use of, a chattel, either alone or with others, and the 'disposal condition' or the 'contribution condition' is met.

(i) Use or possession

The terms 'use' and 'possession' are not defined in the legislation and will therefore have their normal meaning. The question arises as to whether a mere legal right to have possession of the chattel is enough. It is unlikely that it is; it is necessary for control to be assumed by the individual. The Revenue has stated that very limited or occasional use of a chattel will not incur an income tax charge. An example is given of a car used to give occasional lifts (less than three times a month) to the chargeable person will not be liable to an income tax charge whereas a lift to work every day will likely incur an income tax charge (HMRC Inheritance Tax Manual, paras 14333 and 44006).

(ii) The 'disposal condition'

The 'disposal condition' is satisfied where, at any time after 17 March 1986, the individual (whether alone or jointly with others)

- owned the chattel or any other property the disposal proceeds of which were (directly or indirectly) applied by another person to acquire the chattel; and
- disposed of all or part of his interest in the chattel or other property otherwise than by an excluded transaction.

Examples

A father gives a valuable painting to his son which hangs in the son's house and later the father resumes possession of the painting by hanging it in his dining room.

A father gives his valuable stamp collection to his son. The son sells the stamp collection and buys a painting. The father later hangs the painting in his dining room.

(iii) The 'contribution condition

The 'contribution condition' is satisfied when, at any time after 17 March 1986, the chargeable person has provided (directly or indirectly), otherwise than by an excluded transaction, any of the consideration given by another person for the acquisition of:

- the chattel; or
- any other property the disposal proceeds of which were (directly or indirectly) applied by another person towards acquiring the chattel.

Examples

A father gives his son the sum of £100,000 towards buying a painting which is worth £200,000 and which the father later hangs in his dining room.

The provisions will also apply to exchanges. For example, a father gives a painting to his son who exchanges it for a stamp collection which the father has at his house.

A father gives his son £250,000 to acquire a painting which he does and then sells it for £300,000. He uses the proceeds to buy a vintage car which his father has at his house.

A disposition which creates a new interest in a chattel out of an existing interest in a chattel is to be taken to be a disposal of part of the existing interest (FA 2004, Sch 15, para 6(4)).

(iv) The charge

Where FA 2004, Sch 15, para 6 applies in respect of the whole or part of a year of assessment, an amount equal to the 'chargeable amount' is treated as income of the individual which is chargeable to income tax.

The chargeable amount is the 'appropriate amount' less any amounts paid to the owner by the chargeable person under a legal obligation in respect of the possession or use of the chattel. The 'appropriate amount' is calculated by using the formula in FA 2004, Sch 15, para 7. The appropriate amount varies according to whether the disposal or contribution condition applies. The formula is similar to that for land except that instead of the appropriate rental value, para 7 refers to the appropriate amount and the formula uses a notional interest rate which is prescribed by regulation (currently 4%) which can produce a substantial income tax charge.

If a full market rent is paid for the use of chattels then in straightforward circumstances there will be no reservation of benefit because of FA 1986, Sch 20, para 6(1)(a). This will also have the result that the pre-owned asset charge under FA 2004, Sch 15, para 6 will not apply because of FA 2004, Sch 15, para 11(5)(d). It is very important that there is a regular review of the rent to ensure a full market rent is being paid.

There is no *de minimis* value below which chattels may be disregarded. This means that there is no margin for error in determining a full market rent. As, by definition, chattels are movable it may be difficult to track them.

There are three matters to consider in relation to the formula.

First, the valuation date is prescribed by regulations. It has been set as the 6 April in the relevant tax year or, if later, the first day of the taxable period.

Second, regulations provide that the valuation before the first 5-year anniversary is to be made by reference to the first valuation date and thereafter by reference to the valuation at the last 5-year anniversary. This regime is compulsory, not optional, and may have an adverse effect in relation to fluctuating chattel values. If there is an interruption in the use or occupation of the property by the taxpayer so that a fifth-year anniversary does not fall in a taxable period, the relevant date in the year when the provisions of Sch 15 next apply will be treated as the next 5-year anniversary.

Where the chattel in question is the original gift so satisfying the disposal condition, the appropriate amount is computed by the following fraction:

$$\frac{DV}{V}$$

where

DV is the value at the valuation date of the interest in the chattel that was disposed of by the chargeable person; and

V is the value of the chattel at the valuation date.

Example

Bill grants his son a lease of a painting when the painting was worth £500,000 and the lease £400,000. In 2013/14 the painting is worth £3,000,000 and the lease £1,500,000

On the assumption that the prescribed rate is 4%, the appropriate rental value is:

$$£\,3{,}000{,}000 \times \frac{£\,1{,}500{,}000}{£\,3{,}000{,}000} \times 4\% = £\ 60{,}000$$

(v) *Sale of a chattel*

To take account of the fact that, in cases of sales at an undervalue, the sale proceeds may be relevant property comprised in the estate of the chargeable person, the legislation provides that the sale of a whole interest in a chattel by a chargeable person for a consideration paid in money is a non-exempt sale. A proportion is then not subject to the charge. The appropriate amount is reduced by multiplying it by the following fraction:

$$\frac{\text{Appropriate proportion of the value of the interest on the chattel disposed of}}{\text{Value of the chattel}}$$

The appropriate proportion in such a case would be:

$$\frac{MV - P}{MV}$$

where

MV is the value of the interest in the chattel at the time of sale; and

P is the amount paid

Example

Horatio sells to his son, Augustus, a painting worth £2,000,000 at the date of disposal for £1,600,000. At the valuation date the painting is worth £2,500,000.

The appropriate proportion is:

$$\frac{£\,2{,}000{,}000 - £\ 1{,}600{,}000}{£\,2{,}000{,}000} = \frac{1}{5}$$

The appropriate amount is then calculated by the formula in para 7(2):

$$\frac{N \times DV}{V}$$

N is the prescribed interest rate (4%) applied to the value of the chattel at the valuation date; in this case 4% of £2,500,000 = £100,000.

DV is the appropriate proportion of the value of the interest in the chattel disposed of.

DV is £500,000 = 20% of £2,500,000

V is the value of the chattel at the valuation date.

V is £2,500,000

$$\frac{100{,}000 \times 500{,}000}{2{,}500{,}000} = £\,20{,}000$$

It should be remembered that the non-exempt sale relief is only available in respect of cash sales. Also, the relief is only available if the transferor has disposed of his whole interest in the chattel.

The Revenue considers that in relation to the carve-out strategies involving chattels, the provisions of FA 1986, s 102A do not apply (HMRC Inheritance Tax Manual, para 44108).

Settlements

(i) General

[2.36] Under FA 2004, Sch 15 para 8, a charge to income tax will arise where:

(a) there is a settlement under which any income arising from the property would be treated under ITTOIA 2005, s 624 as income of the settlor;
(b) the income would still be deemed to be the income of the settlor even if ITTOIA 2005, s 625(1) did not include any reference to the spouse or civil partner of the settlor; and
(c) the property comprised in the settlement includes property which is, or represents, intangible property settled or added to the settlement after 17 March 1986.

The charge under para 8 adopts an entirely different approach to the provisions relating to land and chattels. Under those provisions the taxpayer must have actually benefited. Under para 8 what matters is the possibility of benefiting. In such a case it might be worth considering selling any intangible investments and purchasing tangible assets such as let land or chattels which are not occupied or used or enjoyed by the taxpayer.

(ii) Intangible property

Intangible property is widely defined and means any property other than chattels or interests in land. This will include cash, shares and insurance policies.

(iii) The charge

The 'chargeable amount' is calculated by applying the prescribed notional rate of interest to the value of the relevant property at the valuation date. The notional rate is prescribed by Regulations and is currently 4%. A deduction from the chargeable amount is given for any income tax or capital gains tax payable by the chargeable person under the following specified charging provisions so far as the tax is attributable to the relevant property.

(i) ITTOIA 2005, s 461 (income tax on chargeable event gains).
(ii) ITTOIA 2005, s 624 (income tax on income arising in settlor-interested trusts).
(iii) ITA 2007, ss 720–730 (income tax on income arising on assets transferred abroad).
(iv) TCGA 1992, s 86 (capital gains tax on gains attributed to settlor of a non-resident trusts).

Unlike under the charge on land and chattels, for a charge to arise there is no need for there to be any benefit arising to the chargeable person nor is there any requirement for there to be any income arising under the settlement.

It should be noticed that the chargeable amount is reduced only by the amount of tax paid under the above provisions, and not for the sums charged to tax. This is a grossly inequitable provision.

Example

> Malcolm settled a property on trust of which he is the life tenant. The property was sold for £500,000 and the moneys are held on deposit earning 3% per annum. Malcolm's marginal income tax rate is 45%.
>
> Malcolm is liable to income tax under ITTOIA 2005, s 624 on the income arising of £15,600.
>
> Assuming a notional rate of interest of 4%, he is also assessable to income tax on notional income under FA 2004, Sch 15 of £20,000. Against this notional income, he can deduct the tax charged on his actual income of £6,750 (45% of £15,000). Therefore, he only receives credit for the tax paid against notional income and not against the tax charged on notional income assessed on him under ITTOIA 2005, s 624.
>
> His income from the settlement is £15,000 and his income tax charge in respect of it is £12,712.50 (£6,750 + ((£20,000 – £6,750) @ 45%)), equal to almost 85% of the income he has received.

Excluded transactions

[2.37] FA 2004, Sch 15, para 10 contains a list of 'excluded transactions' which will not be subject to an income tax charge under the pre-owned assets rules. The HMRC Inheritance Tax Manual at para 44030 states that they 'do not apply to the charge on intangibles' discussed in **2.36** above. That statement is rather misleading as an excluded transaction may involve any kind of property, including intangible property. For example, an excluded transaction could involve intangible property that was later replaced by land or chattels, thus removing the land or chattels in question from the scope of the pre-owned assets charge. There are different exclusions that apply to the different conditions.

Disposal condition

[2.38] For the 'disposal condition' for land and chattels, the following disposals will be excluded transactions.

(a) The 'full consideration' exclusion. A disposal by a chargeable person of his whole interest in the property except for any right expressly reserved by him over the property either
   (i) by a transaction made at arm's length with an unconnected person; or
   (ii) by a transaction which might be expected to be made at arm's length between unconnected persons.

   This would include a third party sale or the sale of land between father and daughter on full commercial terms. If, however, there were any unusual contract terms (of the type a third party would be unlikely to accept) in a sale between connected parties, this is likely to prevent the transaction being an excluded transaction. It should be noted that a disposal of a part interest will not in most circumstances be an excluded transaction with the result that, in the original legislation, equity release schemes were subject to the charge. It has therefore been provided that disposals of part of an interest in any property by a transaction made at arm's length with a person not connected with the chargeable person is specifically exempted from charge (Charge to Income Tax by Reference to Enjoyment of Property Previously Owned Regulations 2005, SI 2005 No 724, reg 5). In addition, the exemption is extended to disposals of a part share to anyone provided that they were made on arm's length terms and either took place before 7 March 2005 or took place on or after that date for a consideration not in the form of money or readily convertible assets. It should be noted that equity release transactions between family members will often be caught by the charge. The definition of a connected person is taken from ITA 2007, s 993 but is extended to include aunt, uncle, nephew and niece (FA 2004, Sch 15, para 2)

(b) Spouse exemption. A transfer of property to the chargeable person's spouse or civil partner (or to a former spouse or civil partner where the transfer has been ordered by a court). A separation agreement would not be sufficient.

   This important exception preserves the ability of married taxpayers or those in civil partnerships to distribute capital assets between them. There is no requirement that the spouse be domiciled in the United Kingdom, so the exemption is wider than the corresponding inheritance tax exemption.

(c) A disposal by way of gift by virtue of which the property became settled property in which a spouse or civil partner (or former spouse or civil partner if done in accordance with a court order) is beneficially entitled provided such an interest in possession has not come to an end otherwise than on the death of the spouse or former spouse. This exemption mirrors the exemption from the reservation of benefit rules found in IHTA 1984 ss 5 and 5A.

(d) A disposition for the maintenance of a family within IHTA 1984, s 11. The Revenue had thought that this provision would have limited application because it was their view that IHTA 1984, s 11 applied only to income and not to a gift of capital. In *McKelvey (Personal Representatives of McKelvey, decd) v Revenue and Customs Comrs* [2008] STC (SCD) 944, [2008] SWTI 1752, the Special Commissioners held otherwise. As a result of the decision, the Revenue advises that where the exclusion is claimed the case should be referred to their Technical Department (HMRC Inheritance Tax Manual, para 44033).

(e) An outright gift to an individual which for inheritance tax purposes is a transfer of value which is wholly exempt because the annual exemption (see **2.7** above) or the small gifts exemption (see **2.13** above) applies.

Gifts covered by other exemptions (eg gifts in consideration of marriage) are not excluded transactions.

Contribution condition

[2.39] Provision by the chargeable person of consideration for another's acquisition of any property will be an excluded transaction in any of the following circumstances.

(i) Spouse exemption. Where the other person was the chargeable person's spouse or civil partner (or, where the transfer has been ordered by the court, his former spouse or civil partner).

(ii) On acquisition, the property became settled property in which his spouse, civil partner or former spouse or civil partner is beneficially entitled to an interest in possession (provided that interest in possession has not come to an end otherwise than on the death of the spouse or civil partner or former spouse or civil partner).

(iii) The consideration provided was an outright gift of money (whether in sterling or foreign currency) by the chargeable person to the other person and was made at least seven years before the earliest date the chargeable person began occupation of the relevant land or obtained possession of the chattel.

This is important as it excludes from the charge all outright gifts of money which were made 7 or more years before the earliest date the chargeable person either entered occupation of the relevant land or obtained possession of the chattel. As the earliest date the conditions can be met is 6 April 2005, any provision of consideration by way of an outright gift of cash made before 6 April 1998 will be an excluded transaction. This will mean that taxpayers will only have to look back to the previous 7 years when tracing gifts of cash used to acquire land or chattels. A problem may still arise where inadequate records have been kept. There is, however, no 7-year limit for gifts of chattels and land which have subsequently been converted to cash which creates a substantial administrative burden on taxpayers.

(iv) The provision of consideration falls within the exemption for dispositions for the maintenance of family under IHTA 1984, s 11. Again, HMRC advises that where this exclusion is claimed, the case should be referred to its Technical Department (see HMRC Inheritance Tax Manual, para 44037).

(v) The provision of consideration is an outright gift to an individual which is wholly exempt because the annual exemption (see **2.7** above) or the small gifts exemption (see **2.13** above) applies.

Example

Rachel and Mark jointly purchased a property in 1995 for £200,000, funding £180,000 of the purchase price by raising a joint mortgage loan. Rachel gave Mark £10,000 which he used to fund his share of the cash funds required. They subsequently married and are still living in the same flat which is now worth £750,000.

The 'contribution condition' is met and Rachel's gift is not an excluded transaction between spouses as they were not married at the time that she made it. Mark will be subject to an income tax charge under FA 2004, Sch 15 based on the $^1/_{20}$th of the rental value of the property, a truly absurd result.

Exemptions from charge

[2.40] There are a number of exemptions from the charges on land, chattels and intangible property which are set out in FA 2004, Sch 15, paras 11–13.

(a) There will be no charge where
  (i) the relevant property, or
  (ii) other property which derives its value from the relevant property and whose value is not substantially less than the relevant property

  is either within the chargeable person's estate for inheritance tax purposes or would be treated as such by virtue of the gifts with reservation rules. Property will form part of a person's estate where it is included in their free estate or where the person has a qualifying interest in possession and will include an interest in possession arising before 22 March 2006 or one of the favoured trusts if the interest arose after that date. It is only necessary that the property forms part of the person's estate, not that inheritance tax is paid on the property. Where the taxpayer's estate includes property whose value derives from the relevant property but whose value is substantially less than the value of the relevant property, then there will be a reduced charge to income tax, taking into account the inclusion of part of the value in the taxpayer's estate.

  In determining the value of property, a deduction is made for an 'excluded liability' in certain circumstances (FA 2004, Sch 15, para 11(6)). A liability is an excluded liability if the creation of the liability and any transaction by which the person's estate came to include relevant property (or property which derives its value from the relevant property or by which the value of property in his estate came to be derived from the relevant property) were associated operations under IHTA 1984, s 268. It appears that this provision was designed to nullify some forms of the trust of debt strategy (see **9.20**) although its precise effect is unclear.

Additional anti-avoidance provisions apply where the property concerned is subsequently treated as forming part of the original transferor's estate by virtue of his coming to have an interest in possession in the property (see **2.41**).

Relevant property is defined in FA 2004, Sch 15, para 11(9) and is determined by the nature of the property involved and whether the disposal or contribution condition is satisfied.

(b) There is an exemption where the property would be treated as subject to a reservation if it were not an exempt transfer under FA 1986, s 102(5)(d)–(i). This includes gifts to charities, political parties, housing associations, maintenance funds for historic buildings and employee trusts and gifts for national purposes. It does not, however, cover transfers between spouses or civil partners, small gifts and gifts in consideration of marriage.

(c) There is an exemption where the property would be treated as subject to a reservation if it were not a share of an interest in land which the transferor and transferee occupy and where the transferor receives no benefit other than a negligible one under FA 1986, s 102B(4). Where a mother gives her son cash which he uses to buy a house jointly with her in which they both live, sharing expenses equally, there is no reservation of benefit. She is not exempt from an income tax charge because her gift of cash was neither a gift subject to a reservation nor a gift of an individual share in land.

(d) There is an exemption where the property would be treated as subject to a reservation were it not for FA 1986, s 102C(3) and Sch 20, para 6. This covers the situation where a transferor gives a house to a relative, the transferor's circumstances have changed since the original gift and the transferor has become unable to maintain himself for reasons of old age, infirmity or otherwise.

(e) There is a *de minimis* exemption where the aggregate of the sums chargeable on an individual in respect of pre-owned assets does not exceed £5,000 in a year of assessment. In such a case, no tax will be payable. If the aggregate exceeds £5,000, it will be fully chargeable. The exemption is applied to the aggregate notional annual values before any amounts paid by the former owner are set off in respect of land and chattels. In practice, this is unlikely to exempt many taxpayers from the charge.

Where the charge applies for only part of the year, the de minimis limit is not apportioned.

Example

> Madge made a gift of the house in which she lives to her nephew. The appropriate rental value is £7,000. She pays rent to her nephew of £5,000 under a formal agreement which reduces the amount chargeable to £2,000.
>
> The *de minimis* rule will not apply as the appropriate rental value exceeds £5,000.

(f) There is no charge on an individual who is not resident in the United Kingdom in a year of assessment. This is considered in more detail in CHAPTER 20 THE OVERSEAS CLIENT.

In determining whether property falls within (*b*), (*c*) or (*d*) above in a case where the contribution condition in **2.34** (land) or **2.35** (chattels) above is met, the exclusion for gifts of money in FA 1986, Sch 20 para 2(2)(b) is to be disregarded (FA 2004, Sch 15 para 11(8)).

Gifts made under deeds of variation or dispositions which are not treated as transfers of value under IHTA 1984, s 17 are disregarded for the purposes of the pre-owned asset charge (FA 2004, Sch 15, para 16).

Where a person ('A') acts as a guarantor in respect of a loan made to another person ('B') by a third party in connection with the acquisition of any property by B, the guarantee is not regarded as the provision by A of consideration for B's acquisition (FA 2004, Sch 15, para 17).

The Revenue has the power by way of regulation to confer further exemptions from income tax.

Reverter to settlor trusts

[2.41] Reverter to settlor trusts have, in the past, been used as tax planning vehicles designed to benefit from the interaction of the gift with reservation rules (FA 1986, s 102) and the pre-owned asset rules (FA 2004, Sch 15). The pre-owned asset charge did not apply if property given away remained comprised in the estate of the transferor for inheritance tax purposes (FA 2004, Sch 15, para 11(1)). Previously, because of IHTA 1984, s 49(1), an individual entitled to a life interest under a settlement was treated as if he owned the trust property which was charged to inheritance tax on his death. Where, however, on the death of the life tenant the property reverted to the settlor of the trust during the settlor's lifetime, although the life tenant was still treated as owning the trust property, its value was left out of account on his death (IHTA 1984, s 53(3)). Therefore a parent could pass property to his child, who then settled the property on trust for his parent's life, subject to which the property reverted to him. Neither the gift with reservation provisions nor the pre-owned assets charge would apply because of s 49, but on the parent's death the value of the property was left out of account. Legislation was introduced to provide that the pre-owned assets charge applies where the former owner of an asset (or a person who contributed to its acquisition) enjoys the asset under the terms of a trust which provides that the trust property may revert to the settlor during his lifetime unless he makes an election (see **2.45**) (FA 2004, Sch 15, paras 11(11)–(13). If an election is made, the pre-owned assets charge will not apply but neither will the revertor to settlor exemption when the interest comes to an end. Of course, (see CHAPTERS **4** and **5**) s 49 only applies to a limited range of interests in possession and so this planning is only relevant to existing IIPs (see **4.9** and **5.3** below) and transitional serial interests (see **5.5** below). Where this strategy has been used it is better for the property to revert to the settlor's spouse (or civil partner) rather than to the settlor so as to preserve the capital gains tax uplift to market value on the death of the life tenant (TCGA 1992, s 73(1)(b)).

Due to a drafting error in FA 2006, s 80, FA 2004, Sch 15, paras 11(11)–(13) have a wider application than was intended. The error is that the amendment made by s 80 applies not only to trusts where the life tenant is another beneficiary but also to those where the life tenant is a settlor himself. Following correspondence between the Chartered Institute of Taxation and HMRC, the Revenue contends that s 80 does not apply provided the life interest of the settlor has subsisted continuously since the creation of the trust. This therefore means that even in HMRC's view there is still a difficulty where the initial trusts were discretionary or conferred interests in possession on other beneficiaries.

The Revenue has said that the effect of s 80 can be avoided by an election being made (see **2.45** below) and so the revertor to settlor provisions do not apply. However the matter may not be straightforward in certain situations such as where land or chattels are held by a non-resident company and the settlor is non-UK domiciled.

Gifts of cash and gifts of land

[2.42] One of the more common scenarios that an adviser encounters is the situation where a parent either makes a gift of cash to their child which is used to buy a property in their joint names or makes a gift of property so the property is held jointly by them. There is a crucial distinction between them which is illustrated below.

Example

Margaret has sold her house and has agreed to buy a house jointly with her daughter, Gillian. Gillian will live with her mother and they will pay all living expenses equally. The tax consequences are as follows.

If Margaret bought the house in her sole name and then transferred a 50% interest to Gillian so they are joint tenants, there would be a gift of an undivided share of an interest in land. The gift is a PET. Because Margaret receives no benefit other than a negligible one (she contributes equally to the household) the gift with reservation rules do not apply (FA 1986, s 102B(4)). No pre-owned asset charge would arise because the disposal satisfies s 102B(4) above (FA 2004, Sch 15 para 11(5)(c)).

If Margaret made a gift of cash (£400,000) to Gillian which is used to buy a house for £800,000, the gift is a PET. Provided the gift was not conditional on Gillian using the money to buy the house there is no gift with reservation. Because it is a gift of money under FA 1986, Sch 20, para 2(2)(b) the tracing rules do not apply. Under FA 1986, Sch 20 para 6(1) one has to consider the associated operations rules under IHTA 1984, s 268. Read literally it is arguable that s 268 applies but many commentators do not consider that the associated operations rule can be used to re-characterise a gift as being of property rather than of cash. However, the comments in the HMRC Inheritance Tax Manual suggest that HMRC may seek to use the s 268 rules in certain circumstances (HMRC Inheritance Tax Manual, para 14372).

In relation to the pre-owned asset charge, it would seem that under FA 2004, Sch 15, para 11(8) the property acquired with the cash is treated as being comprised in the original gift. Therefore, Margaret has given Gillian an undivided share in land and so the exemption from the pre-owned assets charge will apply (see HMRC Inheritance Tax Manual, para 44049).

Valuation

[2.43] Unless otherwise stated, the value of any property will be the price which the property might reasonably be expected to fetch if sold in the open market at that time. There is no assumption that the price be reduced on the grounds that the whole property is to be placed on the market at one and the same time (FA 2004, Sch 15, para 15).

As stated above the valuation is by reference to the first valuation date and this valuation is used for a period of five tax years. When a property has decreased in value over that time the question arises as to what the position is where a property is sold and the taxpayer moves to a smaller property.

Example

Marion gave £700,000 to her son, Martyn, in April 2008. Martyn used the money to purchase 24 Argyll Road. In April 2009 Marion moved to the property. On 6 April 2010 the house was worth £1m on which her income tax charge will be based for the following five tax years. In 2013 Martyn sold the house and bought a small apartment for £500,000 into which Marion moved.

The Revenue has said that 'relevant land' is the land currently occupied by the chargeable person (HMRC Inheritance Tax Manual, para 44011). A new valuation should be made when the occupation of that property starts, and it is intended that the new valuation should then be used for the remainder of that 5-year cycle. Therefore, Marion should obtain a valuation of the apartment to reduce her income tax charge.

Avoidance of multiple charges

[2.44] It is possible that in any year of assessment there is a pre-owned assets charge on land or a chattel, and also a charge on intangible property which derives its value in whole or part from the same land or chattel. The Revenue uses the example of an individual who has settled shares on a settlor interested trust and the company owns the property which he occupies. In such a situation two charges would arise, one in relation to the shares and one in relation to the land.

To avoid multiple charges on the same property FA 2004, Sch 15, para 18 provides that only the higher amount is chargeable and it is that amount which is taken into account for the *de minimis* provisions. FA 2004, Sch 15 para 19 provides that when an income tax charge arises on the same occupation of land or use of any chattel under the pre-owned asset provisions and ITEPA 2003 Pt 3 (benefits from an employer) the income tax charge under ITEPA will take priority with only the excess being subject to a charge under FA 2004, Sch 15.

The Inheritance Tax (Double Charges Relief) Regulations 2005 (SI 2005/3441), gives relief in certain circumstances from a potential double IHT charge which can arise where a taxpayer decides to rearrange his affairs so to avoid a pre-owned asset income tax charge.

Election to opt out

[2.45] Taxpayers who fall within the pre-owned assets provisions may elect to 'opt out' of the charge in relation to a particular asset. Where an election is made in respect of land or chattels, the property is treated for inheritance tax purposes as a gift with reservation which will continue to apply for so long as the taxpayer enjoys a benefit by occupying the relevant land or retaining possession of the chattel and will be subject to inheritance tax on death (FA 2004, Sch 15 para 21). FA 2004, Sch 15, para 22 gives a right of election in respect of intangible property.

The charge to inheritance tax will be incurred unless the occupation or use ceases permanently (and is not recommenced) at least 7 years before their death or (in the case of land or chattels) the chargeable person pays full consideration for use of the relevant property. The Revenue accepts that where the person is already paying full consideration for use of the land or chattels before making an election and then elects there is no deemed PET at that point (HMRC Inheritance Tax Manual, para 44070). However, if the person ceases to pay full consideration in the 7 years prior to death and is still in occupation of the property, the effect of the election is that they will be subject to an inheritance tax charge on their death.

Any election must be made in the prescribed manner (on form IHT 500) no later than the 31 January in the year of assessment immediately following the initial year (the 'relevant filing date') (FA 2004, Sch 15, para 23) or on such later date, as an officer of HMRC may, in a particular case, allow.

The current guidance states that where a taxpayer can show that an event beyond their control prevented them from sending the election by the relevant filing date, a late election will be accepted. In the HMRC Inheritance Tax Manual at para 44077 the Revenue gives examples of what it considers to be an event beyond the chargeable person's control which include an election lost or delayed in the post in certain circumstances and serious illness and bereavement. The Revenue has stated that it will accept a late election:

> 'where the chargeable person can show that they were unaware – and could not reasonably have been aware – that they were liable to the POA charge, and elected within a reasonable time of becoming so aware.'

Unfortunately 'reasonable time' is not defined. The Revenue states that it will only accept a late election provided it is not a result of a chargeable person taking active steps to avoid both a pre-owned assets charge and an inheritance tax charge under the reservation of benefit provisions or a chargeable person wishing to avoid committing to an income tax charge or an election before 31 January in order to have longer to see which will be the most beneficial course of action.

Where there has been a change in the law or HMRC Guidance which results in a charge arising from transactions that did not previously give rise to a charge, a late election will be accepted where the chargeable person can show that they elected as soon as practicable after becoming aware of the change.

There is no right of appeal against the refusal to accept a late election.

In the case of a couple who are married or in a civil partnership who jointly own a property and who are both caught by the provisions of Sch 15, if they both wish to have the property treated as property subject to a reservation, they must both make an election. An election by one cannot affect the other.

An election may be amended or withdrawn, during the life of the chargeable person, at any time before the relevant filing date. Otherwise, an election, once made, cannot be revoked.

There is no provision at present for the transferor to notify the transferee of an election, even though the transferee can be made liable for the inheritance tax due on the transferor's death.

The decision whether to opt out will depend upon a number of factors, including the life expectancy of an individual and the type of assets in the estate. An elderly taxpayer who expects the remaining period of his life to be short may decide to incur an income tax liability rather than have his estate incur a 40% inheritance tax charge.

For more detailed discussion in relation to the application of the pre-owned asset charge on the family home, see **CHAPTER 9 THE FAMILY HOME**.

Capital gains tax implications of a gift

[2.46] The capital gains tax implications of a gift must be considered. A gift of a chargeable asset is a disposal for capital gains tax purposes. Capital gains tax at either 28% or 18% will be payable on any gain arising on a disposal made by a UK resident (TCGA 1992, s 2).

Consideration deemed to be at market value

[2.46A] In many situations the consideration for the acquisition or disposal of an asset will be deemed to be the market value of the asset at that time. This will apply where the disposal was otherwise than by way of a bargain made at arm's length (TCGA 1992, s 17) unless:

'(a) there is no corresponding disposal of it; and
(b) there is no consideration in money or money's worth or the consideration is of an amount or value lower than the market value of the asset.'

Where the parties are connected (for example, a parent and child and a settlor and the trust he has settled are connected for this purpose), the transaction is deemed not to be at arm's length and therefore to take place at market value (TCGA 1992, s 18).

The result is that most disposals within a family, to companies by controlling shareholders and of assets being settled on trusts will be disposals which are deemed to take place at market value. Charges to capital gains tax, therefore, can and often do arise where there are no actual sale proceeds.

Hold-over relief

[2.46B] To modify the harshness of the deemed market value rule, there are two types of hold-over relief. Under TCGA 1992, s 165 and TCGA 1992, s 260, when making a gift it is possible for an election to be made to hold-over certain chargeable gains which would otherwise arise to the transferor. The transferee in effect acquires the gifted property at the transferor's acquisition cost, thus deferring the payment of tax until such time as the transferee disposes of the property in circumstances where it is either not possible to make, or the transferee chooses not to make, a further hold-over election. Hold-over relief is not available on disposals to settlor-interested settlements (or where arrangements subsist under which the settlor may acquire an interest in the settlement) (TCGA 1992, s 169B) nor is it available on a transfer to a trust for the benefit of the settlor's dependent children. A dependent child is defined as a minor who is unmarried or is not a partner in a civil partnership. There is a clawback period during which the held-over gain may be brought back into charge if the settlor later acquires an interest in the settlement or arrangements subsist under which the settlor will or may acquire such an interest. The clawback period begins immediately following the disposal and ends six years after the end of the year of assessment in which the disposal was made (TCGA 1992, s 169C). There are exceptions for heritage maintenance property and certain settlements for disabled persons (TCGA 1992, s 169D).

Gift of business assets

[2.47] TCGA 1992, s 165 applies to gifts by individuals of the following types of assets.

(a) An asset, or an interest in an asset, used for the purposes of a trade, profession or vocation carried on by:
  - (i) the transferor; or
  - (ii) his personal company (as defined in TCGA 1992, s 165(8)(a)); or
  - (iii) a company which is a member of a trading group of companies (as defined in TCGA 1992, s 165A) of which the holding company is the transferor's personal company.

(b) Shares or securities of a trading company (as defined in TCGA 1992, s 165A) or of the holding company of a trading group where:
  - (i) the shares or securities are not listed on a recognised stock exchange; or
  - (ii) the trading company or holding company is the transferor's personal company.

Hold-over relief will not apply to a transfer of shares or securities to a company.

(c) Agricultural property, or an interest in agricultural property, within the meaning of IHTA 1984, Pt V Ch II which is not used for the purposes of a trade carried on as mentioned in (*a*) above. The claim is not limited to the agricultural value of the asset and applies equally to such assets regardless of the rate of agricultural property relief applicable.

Gifts of assets attracting an IHT charge

[2.48] TCGA 1992, s 260 applies to gifts by individuals and trustees to individuals and trustees which are either

(a) chargeable transfers within the meaning of IHTA 1984 (and transfers which would be chargeable transfers but for IHTA 1984, s 19 (the annual exemption)) and which are not potentially exempt transfers; or
(b) exempt transfers within IHTA 1984, s 24 (transfers to political parties), IHTA 1984, s 27 (transfers to maintenance funds for historic buildings) and IHTA 1984, s 30 (transfers of designated property);
(c) transfers of settled property to be held on maintenance funds;
(d) vesting of property held on A&M trusts by virtue of IHTA 1984, s 71(4);
(e) certain transfers of property on which no inheritance tax is charged by virtue of IHTA 1984, ss 71B(2), 71E(2); namely, a transfer from a TBM either to them or on their death or a transfer from an 18–25 trust either to the relevant beneficiary before their 18th birthday or on their death before the age of 18;
(f) transfers of property leaving and entering maintenance funds for heritage property.

In the past, relief under TCGA 1992, s 260 was used mainly in respect of gifts to discretionary trusts, whether or not its value fell within the 'nil rate' band, and on gifts covered by the annual exemption. Since 22 March 2006 relief under s 260 is available for gifts to most types of trust except privileged interest trusts.

The rationale behind the existing statutory rules seems reasonably clear. Where the gift is a potentially exempt transfer and comprises readily realisable assets (eg stock exchange investments) capital gains tax is chargeable on the gift. In the case of most types of illiquid assets (eg land, unquoted shares) either hold-over relief will apply or the tax arising may be paid by equal instalments over 10 years.

Where the gift is subject to inheritance tax or eats into the transferor's 'nil rate' band (which will affect subsequent chargeable transfers), the relief under TCGA 1992, s 260 will be available to avoid any double charge to tax. In cases where both reliefs might otherwise be applicable, TCGA 1992, s 260 relief takes priority over TCGA 1992, s 165 relief (TCGA 1992, s 165(3)(d)).

Making an election

[2.49] A claim for hold-over relief under TCGA 1992, ss 165 or 260 must be made in the prescribed form (found at the end of Help Sheet HS295) by both the transferor and transferee (except where the transferee is a trustee). For gifts made in 2013/14 a claim must be made within four years. In principle it is necessary to agree the amount of the held-over gain. In practice, however, a computation of the gain and formal valuation is in many cases not required (Statement of Practice SP8/92). Both the transferor and transferee need to make the application, provide full details of the asset transferred and confirm that a gain would occur.

Both reliefs operate to defer any chargeable gain arising on the gift until the transferee sells the donated property or otherwise disposes of it in circumstances where it is not possible to make a further hold-over election. Any chargeable gain which would otherwise arise on the gift (called the 'held-over gain') is reduced to zero whilst the transferee's acquisition cost of the donated property is reduced by a like amount so that in effect the transferee takes over the transferor's acquisition cost (TCGA 1992, s 165(4) and TCGA 1992, s 260(3)).

Where the transferor acquired the asset on or before 31 March 1982, his acquisition cost for the purposes of calculating the held-over gain will be the asset's value on 31 March 1982 (TCGA 1992, s 35(2)) except in the circumstances specified in s 35(3), unless an election is made under s 35(5).

Where the disposal of an asset giving rise to a potential capital gains tax charge also gives rise to an inheritance tax charge (either immediately or as a result of the death of the transferor within 7 years) and a claim for hold-over relief is made under either section, the inheritance tax paid may be deducted from the chargeable gain when calculating the capital gains tax due on a subsequent disposal of the asset by the transferee (TCGA 1992, s 165(10) and TCGA 1992, s 260(7)). Alternatively, IHTA 1984, s 165 allows the capital gains tax arising on the gift, provided it is paid by the transferee, to be deducted when calculating the value transferred for inheritance tax purposes.

Example

A transfers her shares in X Ltd to her son B who is 25 years of age and a higher rate taxpayer. The value of the shareholding is £750,000. It has a base cost of £125,000. A has already used her nil rate band. B sells the shares shortly after the gift. Less than a year after the gift A dies. Should A's executors claim hold-over relief allowing B to deduct the inheritance tax chargeable on the gift on his subsequent disposal of the shares or should they bear the capital gains tax on the gift so that it will be deductible in calculating the inheritance tax on the gift?

Claim for hold-over relief

	£	£
IHT on gift (£750,000 @ 40%)		300,000
CGT on subsequent disposal		
Proceeds	750,000	
Deduct: Base cost	–125,000	
Deduct: IHT	–300,000	
	325,000	

Claim for hold-over relief

	£		**£**
	325,000	@ 28%	91,000
			£391,000
No claim for hold-over relief			
Proceeds	750,000		
Deduct: Base cost	–125,000		
	625,000		
	625,000	@ 28%	175,000
Value of shares on gift	750,000		
Deduct: CGT	–175,000		
	575,000	@ 40%	230,000
			£405,000

It can be seen that it is beneficial for the executors to claim holdover relief rather than pay the capital gains tax.

Where an election is made for hold-over relief under TCGA 1992, s 165 or TCGA 1992, s 260 (or has been made prior to 14 March 1989 under FA 1980, s 79), the held-over gain can in certain circumstances be assessed on the transferor (but in the name of, and at the rates applicable to, the transferee) if the transferee becomes non-UK resident within 6 years after the end of the year of assessment in which the relevant disposal took place and the asset has not been disposed of (TCGA 1992, 168(7), (8)).

To protect the transferor against any contingent liability, the following methods may be adopted:

(a) the retention by him of an amount of the donated property equal to the held-over gain as bare trustee for the transferee for the 6-year period; and
(b) the taking of indemnities from relatives of the transferee who are not likely to go abroad,

Both of these, however, may represent 'reserved benefits' thereby possibly tainting the gift for inheritance tax purposes.

Clawback of relief

Clawback on trust becoming settlor interested

[2.50] Hold-over relief may be clawed back under provisions in TCGA 1992, s 169C. If, during the clawback period, either of the following two conditions is met, then the relief is withdrawn and the capital gains tax which would have been payable but for the relief will be clawed back:

- during the clawback period, the settlement becomes settlor-interested or an arrangement subsists under which a settlor will or may acquire an interest;
- in computing the chargeable gain which would (assuming that the transfer had not been eligible for holdover relief) accrue to the transferor on the disposal, the allowable expenditure would fall to be reduced as a consequence, either directly or indirectly, of a claim under TCGA 1992, s 165 or s 260 in respect of an earlier disposal made by an individual (whether or not to the transferor) and at any time during the clawback period the individual has an interest in the settlement or an arrangement subsists under which such interest will or may be acquired by him.

The clawback period is the period beginning immediately after the making of the relevant disposal and ending six years after the end of the year of assessment in which that disposal was made. Where the clawback provisions apply, a chargeable gain equal to the amount of the held-over gain on the relevant disposal is treated, for the purposes of tax in respect of chargeable gains, as accruing to the transferor at the time either of the two conditions above is fulfilled.

Example

A transfers her shares in X Ltd to her son B who is 25 years of age. The value of the shareholding is £750,000. The shares have a base cost of £125,000. A year later, the market value of the shares has risen to £850,000. B makes a gift of the shares into a settlement from which he and his wife are excluded from benefit. Once again, an election is made to hold-over the gain. The trust contains a power for the trustees, at the behest of the settlor (B) to add beneficiaries to the settlement. The power cannot be exercised in favour of the settlor, his spouse or civil partner. Five years after making the transfer to the trustees, B enters an agreement with the trustees under which, should B die before his mother, A, the trustees will add A to the settlement as a life tenant of a portion of the trust fund.

A charge will not arise under TCGA 1992, s 169C by reason of the arrangement. B has not acquired an interest in the settlement. A has done so but, in the absence of any sort of arrangements between A and B as to the making of the settlement, she is not a settlor of the settlement.

There is an exemption from the clawback provisions in relation to a disposal to the trustees of a settlement which is a heritage maintenance settlement or is a settlement for disabled persons, provided certain criteria in TCGA 1992, s 169D are fulfilled.

Clawback on death

[2.51] Where a gain has been held-over into a trust which is or becomes an interest in possession, the held-over gain crystallises on the death of the life tenant (TCGA 1992, s 74(2)).

The inability to claim hold-over relief on gifts to non-residents (TCGA 1992, s 166 and TCGA 1992, s 261) makes gifts of chargeable assets to non-resident trusts unattractive, although there can be circumstances where the immediate capital gains tax charge is an acceptable price to pay for the ability to defer payment of any future capital gains tax on a subsequent disposal of the assets by the trustees, especially where the capital gains tax can be paid by instalments.

Paying the tax by instalments

[2.52] Under TCGA 1992, s 281, the instalment option applies to the following assets:

(a) land or an estate or interest in land;
(b) shares or securities giving control of a company;
(c) shares or securities not listed on a recognised stock exchange.

Interest on the unpaid tax will run from the due date and not from the date on which each instalment is due. This detracts from the attraction of the facility.

Capital gains tax considerations in making a gift

[2.53] Taking account of capital gains tax is an essential element of lifetime estate planning. Both the nature of assets to be given away and the identity of the transferee need to be carefully considered, as will the funding of any tax charge arising. The following points should be borne in mind when considering any planning strategy.

(1) Where a gift is being made solely to save inheritance tax at 40%, an immediate charge to capital gains tax at either 18% or 28%, depending upon whether the transferor is a higher rate taxpayer, may be worth incurring for the potential inheritance tax saving. There is an obvious cash flow advantage in deferring any tax charges for as long as possible (ie until death when there will also be the benefit of the capital gains tax free base uplift) although the risk in such a strategy is that the rates of inheritance tax may change for the worse or a less favourable form of taxation may come into force. Another relevant factor is the extent to which the current value of the asset reflects an accrued chargeable gain — the charge to capital gains tax is only on the amount of the gain whereas the charge to inheritance tax will be on the asset's full value, including any increase in the value of the asset as time goes on. Where an asset is expected to increase significantly in value, an immediate gift of it (even if subject to an immediate capital gains tax charge) will save inheritance tax both on its present value and on the 'growth' element.
(2) Gifts of non-chargeable assets (eg cash, gilts, qualifying corporate bonds, life policies and chattels under £6,000 in value) will not give rise to a capital gains tax charge.
(3) Chargeable assets showing the lowest gain should be identified and given away.

(4) The capital gains tax arising on a gift may be reduced if the transferor also realises capital losses (eg by sales or by gifts to the same transferee) in the same tax year. Although one needs to consider the provisions of FA 2007, s 27 which disallow losses arising under arrangements, one of the main purposes of which is to obtain a tax advantage.

(5) Where the gift is a potentially exempt transfer and a chargeable gain arises which cannot be held-over, the tax should be paid by the transferee so that, if the transferor dies within 7 years of the gift, the tax paid will reduce the value transferred by the chargeable transfer (IHTA 1984, s 165). There is a possibility that any agreement between the transferor and the transferee that the transferee will be responsible for the capital gains tax might create a 'gift with reservation' for inheritance tax purposes. On the transferee paying the tax, the benefit would then come to an end and the transferor would be deemed by FA 1986, s 102(4) to have made a further disposition of the property by way of a potentially exempt transfer. This will, in effect, start an additional 7-year period running which the transferor must survive to avoid an inheritance tax charge. The authors, however, have never known HMRC to raise this argument.

(6) Where possible, advantage should be taken of the option to pay the capital gains tax by instalments.

(7) Gifts of chargeable assets should be made by whichever spouse has an available annual exemption or available capital losses. To allow this to be done, it may be necessary for one spouse to first give the asset to the other. This is, of course, subject to a possible challenge under the provisions of FA 2007, s 27 which disallows losses arising under arrangements, one of the main purposes of which is to obtain a tax advantage. In addition, the application of the GAAR to such arrangements should also be considered.

(8) Because moving assets around a family may create a capital gains tax charge, it is very important that chargeable assets are acquired by the right person (whether an individual or a family trust) at the outset.

Stamp duty and stamp duty land tax

[2.54] Stamp duty is not chargeable on an instrument giving effect to a gift of shares provided that it can be certified in writing as falling within Category L of the Schedule to the Stamp Duty (Exempt Instruments) Regulations 1987 (SI 1987/516).

For the transfer of land by way of gift, no stamp duty land tax will be payable.

Advice should be sought where the transferee is assuming a liability, for example, a mortgage, as the assumption of any debt will constitute chargeable consideration (FA 2003, Sch 4, para 87) on which stamp duty or stamp duty land tax may be payable.

Which assets to give away?

[2.55] Given that there are a number of ways in which an individual may make immediate gifts without incurring an immediate charge to inheritance tax or capital gains tax, the next aspect to consider is whether in fact he has any assets which he can afford to give away. This can be a very difficult matter. On the one hand, the individual may be concerned about the amount of tax that will be payable on his death, or on the death of his wife, but on the other he may be very reluctant to jeopardise his or his wife's present and future standard of living and financial security. He should only be encouraged to give away those assets which are clearly surplus to his present and estimated future living requirements. In theory, the more wealthy a person is, the more surplus assets he will have. In practice, however, it is often the case that the more wealthy a person is, the more he will want to retain to cushion and secure his, usually high, standard of living. The inheritance tax 'gifts with reservation' provisions, as we have seen, can make it extremely difficult for a person to give away an asset whilst retaining the ability to get it back in times of hardship. In addition, the income tax charge levied on pre-owned assets will act as a deterrent. There are various insurance products which allow individuals to make large transfers out of their estates whilst retaining a right to 'income' during their lifetime. These products have been designed to avoid the reservation of benefit rules. For a more detailed consideration see CHAPTER 7 INSURANCE. It should be emphasised that most effective estate planning has to be conducted on the basis that once an asset is given away, it is gone for good. Whilst every case is different and must be judged on its own merit, the following are the types of assets which are usually the most suitable subjects of gifts.

Non- or low-income-producing assets

[2.56] Many people tend to live off their income (whether earned or unearned), regarding their capital primarily as a source of income and secondly as a reserve which can be called upon in times of hardship. Any assets which produce little or no income may be suitable for giving away, although it is important not to forget the psychological importance of the mere existence of the reserve.

Unfortunately, in many cases, the major non-income producing asset – indeed the major asset itself – will be the principal residence and the gifts with reservation provisions have rendered ineffective most methods of giving away the entire home whilst retaining the ability to live there. There may be more scope for estate planning with regard to a second home, but again the possible implications of these provisions must be fully explored. These aspects are dealt with in greater detail in CHAPTER 9 THE FAMILY HOME.

On the other hand, valuable paintings, books or similar chattels are clearly suitable candidates, provided that both ownership and (to avoid any reservation of benefit) possession are ceded. Woodlands, another non-income-producing asset, is a possible candidate.

Assets likely to grow in value or suffering a temporary reduction in value

[2.57] These types of assets, such as shares in private companies or let property, are obvious candidates because of the advantage in taking the future growth out of the transferor's estate.

In making gifts of assets which are pregnant with gain or in respect of which significant gains are anticipated, it is important to bear in mind that whilst the asset will on the transferor's death escape the charge to inheritance tax, the ability of the transferor's heirs to acquire, for capital gains tax purposes, the asset at its market value at the death of the transferor under TCGA 1992, s 62(1), thereby wiping out any chargeable gain then latent in the value of the asset, will be lost. This may be a significant factor if it is anticipated that the assets will one day be sold by the transferee.

Because the rate of capital gains tax is now either 18% or 28%, depending upon whether the transferor is a higher rate taxpayer, it may be attractive for an individual to make a gift of an asset and pay 18% or 28% (or a combination of both) on any capital gain rather than to hold the asset until death when IHT at 40% would be payable.

Where a transferor has property which is capable of qualifying for inheritance tax business property relief or agricultural property relief and that asset is both pregnant with gain and likely to be sold by the intended transferee it may, for tax purposes, be beneficial to allow the property to pass to the intended transferee on the transferor's death. This would allow advantage to be taken of the capital gains tax-free uplift to base cost. This would be preferable to removing the property from the transferor's estate only to permit the transferee then to suffer a 10%–28% capital gains tax charge on a gain arising on the sale. Obviously, much will depend on how much of the value of the asset reflects a potentially chargeable gain and the level of inheritance tax relief available.

The other factor which now has to be considered is whether, on the gift, any capital gain already latent in the value of the asset can be 'held-over' to the transferee. This will depend upon the nature of the asset and the type of gift – see **2.46** above. In the case of shares in private companies, hold-over relief may be available; but in relation to other assets where the relief is not available, an immediate charge to capital gains tax may be a small price to pay to take the expected increase in value out of the transferor's estate.

Creating surplus assets to give away

[2.58] It is sometimes possible to create surplus assets where none appear to exist. For example, an investment portfolio worth £100,000 and yielding (say) 2%, could be split into two. One half is then invested in higher yielding fixed interest investments to produce (say) a 4% yield and the other half is then free to be given away. This releases assets for a gift whilst maintaining the current income. Two points should, however, be borne in mind. First, the re-investment may create a significant capital gains tax charge. Secondly, the investment in fixed interest securities is unlikely to have any potential for significant capital growth in the future.

Encouraging an individual to live off capital itself rather than the income produced by that capital is another way of creating a surplus. Consider, for example, an elderly person who expects to live for another ten years and who has an investment portfolio worth £1,000,000 which produces an annual income of £30,000. He could retain £500,000, giving away the balance of £500,000. The individual could then fund a part of his annual expenditure from capital.

Another method which is sometimes suggested for freeing assets, otherwise required to produce income, is for an individual to borrow (usually on the security of his home) in order to buy an annuity, the income of which is intended (after tax) to cover the mortgage payments and provide a suitable level of maintenance. However, the annuity rates are unlikely to be attractive (they are usually below the life office's normal rates) and the net return after the interest payments have been made is often poor. The loss caused if the individual dies prematurely can wipe out the benefit of any saving in inheritance tax as the individual is exposed to the risk of fluctuating property prices and interest rates.

The grant of a tenancy can be used to reduce the value of land to facilitate a gift of the land. The grant of any tenancy which confers statutory security of tenure on the tenant, or which confers a significant term of years on the tenant, will effect an immediate reduction in the value of the property over which the tenancy is granted. In the case of a rack rent agricultural tenancy this can be by a substantial amount. The grant may have inheritance tax, capital gains tax and income tax implications all of which will need to be considered. The main use in estate planning of the granting of a tenancy specifically to reduce value is to enable a subsequent transfer of the freehold reversion to be made to the tenant at a significantly lower value than if the unencumbered freehold had been transferred. Again, this technique is subject to the application of FA 1986, s 102A and the GAAR. It is also considered in more detail in **Chapter 11 The Family Farm**.

Cash gifts

[2.59] Gifts of cash and investments are both equally effective for inheritance tax purposes. There are, however, two points worth considering.

(1) If an individual is contemplating giving his son a cash sum in order for him to buy, say, a car, it is often said that it is better for the individual to buy the car himself and then give it to his son. The second-hand value of the car is likely to be less than the amount of the cash gift. Clearly, this device will only work in relation to assets which depreciate on resale (unlike land) and, in practice, is only worth doing in respect of assets which are of substantial value and exempt from capital gains tax. Furthermore, the purchase and the gift are so clearly associated operations within IHTA 1984, s 268 that the transferor will be chargeable on the total loss to his estate resulting from the purchase and the gift if one is made in contemplation of the other.

(2) Gifts of investments may give rise to a capital gains tax charge where these are chargeable assets which cannot be 'held over' under either TCGA 1992, s 165 or s 260.

The transferee

[2.60] An individual who has decided that he wants to give assets away and has identified those assets which are surplus to his requirements must also consider the recipient of the gift and the manner in which the gift should be made.

Where the individual is considering a gift to his children, and there are also grandchildren in existence, some thought should be given to skipping the first generation and passing the assets over to the second. This is a course which usually only commends itself to children who consider themselves already adequately provided for, but any property passed to the second generation may, if held in trust, be used to maintain the grandchildren and to meet the cost of their education in an income tax efficient manner (see below). Such an approach can thus indirectly benefit their parents as well.

A gift may be in the form of an outright gift to an individual or may be a gift into trust. It used to be the case that the most common types of trust encountered in estate planning were:

(a) a bare trust for the benefit of a minor;
(b) an accumulation and maintenance trust for children and/or grandchildren;
(c) a discretionary trust;
(d) an interest in possession (life interest) trust.

Gifts to individuals, disabled trusts and the deemed transfer of value where an immediate post death interest is succeeded by a bereaved minors trust are potentially exempt transfers. Whereas, gifts to discretionary trusts, accumulation and maintenance trusts, and most interest in possession trusts, are not potentially exempt transfers. Discretionary trusts are now most likely to be used as vehicles to receive regular gifts within the inheritance tax annual or 'normal expenditure out of income' exemptions or gifts within a person's nil rate tax band, particularly in view of their flexibility.

Each type of trust has its own uses and limitations and these are dealt with in more detail in Chapter 4 Creating Settlements. The advantages and disadvantages of a gift to an offshore trust are also briefly discussed in the same chapter, although a more detailed analysis is contained in Chapter 6 Offshore Trusts.

An outright gift to a trust for the benefit of a minor child of the transferor does not provide any income tax advantage. Any income arising on the property given away is taxed as part of the transferor's total income under ITTOIA 2005, s 629 whilst the child is a relevant child (that is, an unmarried minor child not in a civil partnership), subject to the £100 limit for small amounts of income. It used to be the case that gains arising to a trust under which the settlor's dependent children could benefit would be assessable on the settlor. This is no longer the case.

It was the case that up until 23 June 2010 gains were taxed at a flat rate of 18% for both trustees and individuals alike, so there was no tax benefit in making a gift to one rather than to the other. This has changed because a higher rate of 28% applies for individuals where their total taxable income and gains exceed the basic rate income tax band (currently £35,000). Where an individual's total taxable income and gains do not exceed the limit, gains remain taxable at 18%. For trustees, there is a flat rate of capital gains tax at 28%.

Making a gift

[2.61] A gift of property may be effected in two ways, namely by the appropriate transfer of ownership or by a declaration of trust by the owner. A gift by way of declaration of trust will take effect on the date of the declaration. A gift by transfer of ownership will take effect on the date of the transfer. A gratuitous disposition of heritable subjects in Scotland takes place when it is delivered to the transferee and not when it is recorded in the Register of Sasines (*Marquess of Linlithgow v Revenue & Customs Commissioners* [2010] CSIH 19, [2010] STC 1563).

In the case of gifts to trustees there are further requirements; there must be an effective transfer of property on trusts that are certain and are administratively workable. In reality, there should be little difficulty in establishing that the trust property has been given in a manner complying with the appropriate legal formalities, and some of these rules are set out below. In practice, if difficulties are going to arise it is far more likely that this will be because the gift has not been perfected. As a general rule, if the transferor does not complete all the formalities associated with the gift, then it will fail (*Fry, Re, Chase National Executors and Trustees Corpn Ltd v Fry* [1946] Ch 312, [1946] 2 All ER 106); if the transferor (including his agents) has accomplished all that can reasonably be undertaken, but an independent third party delays the legal formalities, the gift is valid (*Rose, Re* [1952] Ch 499, [1952] 1 All ER 1217). (See also the decision in *Pennington v Waine* [2002] EWCA Civ 227, [2002] 4 All ER 215.)

Transfers of some types of property (eg registered stocks and shares, land, life assurance policies) can only be effected by an instrument of transfer.

If a transfer of chattels is made by deed, except in the case of a marriage settlement, the chattels must be delivered to the transferee and registered under the Bills of Sale Act 1878 if it is not to become void as against the transferor's trustee in bankruptcy and creditors. Where possession remains with the transferor, a complete gift of chattels should be effected by a bill of sale. The registration process is not straightforward and it should be remembered that the register is a public document. For many clients, the lack of confidentiality if there are conditions attached to the gift is particularly off-putting.

Delivery is effected by change of possession. Where the chattel is in the possession of a third party, the transferor must indicate to the third party that he is to look to the transferee as the owner of the chattel. Where the chattel is already in the possession of the transferee, the transfer may be effected simply by words (oral or written) indicating an intention to transfer ownership (*Stoneham (Re)* [1919] 1 Ch 149). Gifts of money in the form of bank notes or an irrevocable banker's draft are made by delivery. Gifts by way of cheque are not effective until the transferee's account is credited (*Owen Dec'd (Re)* [1949] 1 All ER 901). This principle was applied in *Curnock (Personal Representative of Curnock (dec'd)) v IRC* [2003] STC (SCD) 283, (SpC 365)).

Evidencing the gift

[2.61A] It is important to retain evidence of a gift or to make clear whether the transaction is a gift or a loan. The case of *Silber (personal representative of the estate of Lerner, deceased) v Revenue and Customs Comrs* (TC 2369) [2012] UKFTT 700 (TC), [2013] SWTI 326 concerned whether a payment was a loan or a gift. The Revenue successfully argued there was no evidence that the transaction had been a gift and indeed it was shown in the company accounts as an amount due to the deceased as a creditor. It is important that evidence is retained as to the nature of a payment and that accounts and similar documentation adequately reflect the nature of the transaction.

Order of gifts

[2.62] When making a number of gifts, care should be taken to ensure that they are made in the most tax efficient order. Where a number of gifts are to be made which are all potentially exempt transfers, the order is important if the transferor survives the gifts by 3 years but dies within 7 years of them. Where the transferor survives the potentially exempt transfer by 7 years, then the order is immaterial. It is also usually immaterial if the transferor dies within 3 years of the gifts because then they will all be chargeable at death rates. There is some merit in all the gifts being made on the same day so that any inheritance tax payable as a result of the gifts (whether immediately payable or payable as a result of the transferor's death within 7 years) is charged on each gift on a pro-rata basis. This is the effect of IHTA 1984, s 266(2) and avoids the later gifts bearing the tax charge due to the earlier gifts using up the nil rate band and any exemptions.

Where, however, the proposed gifts include both a chargeable transfer (a transfer to a discretionary trust or interest in possession trust) and potentially exempt transfers, the chargeable transfer should be made before the potentially exempt transfers. This is because if the potentially exempt transfer becomes chargeable it will not be necessary to recalculate the tax on the chargeable transfer. In addition, currently any nil rate band would be used by the discretionary trust which would have an impact in reducing future rates of charge on the trust. At the time of writing, a Consultation Document 'Inheritance Tax: Simplifying Charges on Trusts – The Next Stage' has been published, the proposals of which may reduce the nil-rate band's effect on future charges.

The most important point is that, where tax is paid on a lifetime chargeable transfer, it is impossible to obtain a refund of any of the tax paid in the event of the recomputation of the tax on death producing a lower liability as a result of taper relief (IHTA 1984, s 7(5)). Of course, in the converse position, additional tax would indeed be due. This means that the order of making gifts can be very important where potentially exempt transfers and chargeable transfers together exceed the transferor's nil rate band. The following example, ignoring annual exemptions, illustrates the point.

Example

Horace wished to make two gifts, one of £325,000 to his daughter, Rebecca and one of £340,000 to a discretionary trust for the benefit of his grandchildren.

The gift to Rebecca would be a potentially exempt transfer whereas the gift to the discretionary trust would be a lifetime chargeable transfer.

Horace made the gift to Rebecca first. Horace died six years later.Taper relief will be available.

The effect of the potentially exempt transfer being made first:

			Tax £
Day 1:	Gift to Rebecca of £325,000		Nil
Day 2:	Gift to the discretionary trustees of £340,000 The trustees pay the tax (340,000 – 325,000) @ 40% × 50%		3,000
Further tax due on Horace's death: No tax is due on the PET because it falls within the nil rate band of £325,000			Nil
Tax on chargeable transfer allowing for taper relief:			
340,000 @ 40% × 20%		27,200	
Deduct: Tax previously paid by the trustees		–3,000	
			24,200
Total tax			£27,200

If, however, Horace had made the gift to the trustees before the gift to Rebecca the situation would have been different.

			£
Day 1:	Gift to the discretionary trustees Trustees pay the tax (340,000 – 325,000) @ 40% × 50%		3,000
Day 2:	Gift to Rebecca of £325,000		Nil
Further tax due on Horace's death: Tax on chargeable transfer:			
(340,000 – 325,000) @ 40% × 20%		1,200	
Deduct: Tax paid		–3,000	
			Nil
Tax paid on potentially exempt transfer:			
325,000 @ 40% × 20%			26,000
			£29,000

Who should pay the inheritance tax on lifetime gifts?

[2.63] It is always important for the transferor to decide whether he or the transferee should pay the inheritance tax on a gift.

With immediately chargeable lifetime transfers such as those made to non-privileged trusts the transferor is primarily liable to pay the tax (IHTA 1984, s 199). The gross value of the gift will therefore need to be calculated to reflect the loss to the transferor's estate which will include the inheritance tax liability arising by reason of the transfer. Alternatively the transferee, namely the trustees, could pay the tax from the value transferred, therefore avoiding the need to gross up.

For potentially exempt transfers, inheritance tax will only be due if the transferor fails to survive for the necessary 7-year period. If he fails to do so and tax becomes payable, there is no question of grossing-up as the transferor himself has no liability to pay the tax so that the provisions which allow the liabilities to be taken into account in determining the value of a transferor's estate immediately after the transfer do not apply (IHTA 1984, s 5(4)).

The tax liability on a potentially exempt transfer which becomes chargeable falls primarily on the transferee. If, however, the tax is not paid within 12 months after the end of the month in which the transferor died, the transferor's personal representatives also become liable (IHTA 1984, s 204(8)). To avoid any question as between the transferee and the transferor's personal representatives as to who should pay the tax, the matter should be settled at the outset. If the transferee is to pay the tax – and in many cases this is the preferable course especially if the interest-free instalment option is likely to be available – the transferee should enter into a binding commitment to do so. It is difficult to see that such a commitment could amount to a 'reserved benefit' for the transferor as it does no more than reflect where the primary statutory liability for the tax falls. The Revenue is understood to take the same view. If, however, the transferor wishes the tax to be borne by his estate, then a specific provision to this effect should be put in his will. This would amount to a legacy in favour of the transferee for inheritance tax purposes, and if the will includes gifts of residue which in whole or in part qualify for exemption, then the legacy may have to be grossed-up when calculating the inheritance tax payable on the transferor's death (IHTA 1984, s 38).

There are two distinct advantages in ensuring that the burden of the tax falls on the transferee.

(1) In the case of a chargeable transfer, there will be no 'grossing-up' (ie when calculating the inheritance tax payable no account will be taken of the tax itself in determining the reduction in the transferor's estate).
(2) Where the donated property is land, shares or securities in a company which gave the deceased control of that company or certain non-controlling holdings of shares or securities there may, where applicable, be the option of paying any inheritance tax by ten equal annual interest-free instalments. The payment of the tax may then be funded by the transferor by his making further gifts to the transferee within his annual exemption or regular gifts within the 'normal expenditure out of income' exemption. In the case of the inheritance tax payable in respect

of a potentially exempt transfer, the interest-free instalment option (if available) may depend on the transferee retaining the donated property until the death of the transferor or until his own death if he predeceases the transferor.

Term assurance

[2.64] Regardless of whether the inheritance tax is to be borne by the transferee or by the transferor's personal representatives, consideration should be given to term assurance being effected on the life of the transferor. The term should be for 7 years but the policy should ideally have an option to extend the term to cater for any legislative changes. Where the liability to tax is to be borne by the transferee, the policy may be taken out either by the transferee, as he has an insurable interest in the life of the transferor, or by the transferor himself and then assigned to the transferee. Where the liability is to be borne by the transferor's personal representatives, the transferor should take out the policy and ensure that the policy proceeds do not form part of his estate on death by holding the policy on separate trusts, either similar in terms to those in his will concerning his residuary estate or (where appropriate) wide discretionary trusts for the benefit of his family. The premiums on the policy may continue to be paid by the transferor and if met out of income may be exempt from inheritance tax within the 'normal expenditure out of income' exemption. Otherwise, the premiums may be covered by the annual exemption. In the case of a policy taken out by or for the transferee, decreasing term assurance may be appropriate as the tax charge decreases as time elapses. In the case of a policy taken out by the transferor, however, decreasing term assurance may well be inappropriate since although the tax payable on the potentially exempt transfer will decrease, the amount of the potentially exempt transfer will be aggregated with the transferor's estate on death and may therefore operate to increase the overall rate at which his estate is taxed. Indeed, it may be worth considering additional insurance cover to meet this potential increased liability.

Who should pay the capital gains tax?

[2.65] If the gift gives rise to a chargeable gain which cannot be held-over, then the primary liability for the tax falls on the transferor. However, under TCGA 1992, s 282, if the tax is not paid by the transferor within 12 months from the date when it becomes payable, the transferee may be assessed and charged (in the name of the transferor) to the tax.

The advantage of the transferee bearing the burden of the tax is that if the gift is, or becomes (by reason of the death of the transferor), a chargeable transfer for inheritance tax purposes, the amount of capital gains tax borne by the transferee is treated as reducing the value transferred by the chargeable transfer (IHTA 1984, s 165).

It is possible that any agreement between the transferor and the transferee that the transferee should be responsible for the capital gains tax might amount to a 'gift with reservation' for inheritance tax purposes. However, even if this were to be the case, the reservation of benefit should cease on the tax being paid by the transferee, with the result that a second potentially exempt transfer would be made by the transferor at that time (FA 1986, s 102(4)).

The option of paying capital gains tax by instalments conferred in certain circumstances by TCGA 1992, s 281 applies whether the tax is paid by the transferor or the transferee.

Liability offset

[2.66] The second method by which the inheritance tax payable on death may be mitigated is by an individual taking out a loan. In valuing an individual's estate, all liabilities in existence at the time are taken into account (IHTA 1984, s 5(3)) subject to the various exceptions including those introduced by FA 2013 which are discussed below. A liability of the transferor is only taken into account to the extent that it was incurred for consideration in money or money's worth (IHTA 1984, s 5(5)). As a general rule, debts are deducted against the value of the assets in the deceased's free estate except where the loan is secured against a property, in which case that liability is taken to reduce the value of the property (IHTA 1984, s 162(4)). Therefore an individual could borrow money secured against, for example, his home and then use the borrowed funds to make a gift of cash to a family member which would be a potentially exempt transfer and, provided he survived for seven years, would fall outside of his estate for inheritance tax purposes. The secured loan would reduce the value of the property against which it was secured thus reducing the inheritance tax payable on death. One has to consider the anti-avoidance provisions found in FA 1986, s 103 that are designed to prevent the artificial creation of liabilities. Section 103 applies where consideration given by the creditor consisted of property derived from the deceased or other consideration given by a person who was at any time entitled to, or whose resources included at any time, property derived from the deceased. Alternatively, the moneys were used to acquire assets which would qualify for relief such as Business Property Relief, Agricultural Property Relief or Woodlands Relief. Again, the loan would reduce the value of the asset against which it was secured and relief would be available on the qualifying assets provided the requisite conditions were satisfied. Non-domiciled individuals would use the funds to acquire property situated outside the UK which would be excluded property and so not chargeable to inheritance tax.

This type of planning, whilst not suitable for some clients, has played a part in many client's estate planning strategies. Interestingly, the GAAR Guidance at para D31 gives an example of a non-domiciliary borrowing to purchase a UK property which HMRC conclude is not caught by the GAAR.

Legislation was introduced in FA 2013 to restrict the deduction of liabilities depending upon the purpose of the loan or whether, on death, the loan is repaid. Essentially, there will be a restriction where:

(a) the borrowed funds were used to acquire, maintain or enhance excluded property;

(b) the borrowed funds were used to acquire, maintain or enhance assets that qualify for Agricultural Property Relief, Business Property Relief or Woodlands Relief;
(c) on death, the liability is not repaid or discharged out of the estate.

Where (c) above applies, the debt will still be deductible if there is a real commercial reason why the liability is not discharged, it is not the purpose of leaving the loan outstanding to obtain a tax advantage and the deduction of the liability is not otherwise prevented.

Loan used to acquire excluded property

[2.67] Where borrowed funds are used to:

(a) directly or indirectly to acquire excluded property; or
(b) for the maintenance or enhancement of the value of any excluded property.

the borrowed moneys would be first deducted against those assets with any excess being deducted against any remaining chargeable assets.

As mentioned above, borrowed funds must be used for the acquisition of excluded property which should be relatively straightforward to identify. In addition, if such funds are used for the maintenance or enhancement of the value of such property that is also caught by the provisions. HMRC in their Guidance state that the words should be given their normal meaning. They then go on to say that 'maintain' means 'to keep in good or proper order' and of 'enhance' it says means 'to improve or augment' (HMRC Inheritance Tax Manual, para 28012). The *Shorter Oxford English Dictionary* defines 'maintenance' as 'the action of keeping something in working order, in repair, etc; the keeping up of a building'. One might argue that this is a slightly lower level than HMRC's meaning, in which case certain expenditure to keep a building in working order would not fall within IHTA 1984, s 162A but expenditure to ensure it is in good order would be. 'Enhance' is defined in the *Shorter Oxford English Dictionary* as 'raise (a price or value); . . . of property: rise in price . . . improve in quality'.

Directly or indirectly

[2.68] The legislation will apply where funds are used directly or indirectly for the purchase, maintenance or enhancement of excluded property. It is apparent from HMRC's Guidance at para 28018 that they take a very broad view of the meaning of 'directly or indirectly'. There is no motive test and so the intention of the individual when taking out the loan is immaterial. It does not matter that, at the time the loan was taken out, the individual had no intention to acquire excluded property or use it for the enhancement or maintenance of such property. On the authority of *IRC v Stype Investment (Jersey) Limited 1983* (unreported) it is HMRC's view that any property into which the borrowed funds can be traced is subject to IHTA 1984, s 162A. It does not matter how many steps are attributed to the acquisition of the excluded property or the timescale involved. Each case, HMRC say, will depend on the facts. The only comfort that a taxpayer has is that 'it must be possible to reasonably attribute the acquisition of the excluded property to the borrowed funds before the deduction of the loan is disallowed'. HMRC's Manual gives a number of examples of when, in their view, a loan is not deductible. What is clear is that where loans are taken out a comprehensive paper trail should be retained.

Example

Ganni is resident but not domiciled in the UK. He has a house in London but wishes to buy an estancia in Argentina for £1 million. He borrows £500,000 from a UK bank which is secured on his London house. The loan cannot be used to reduce the value of his UK home under IHTA 1984, s 162A. If he had used the funds to buy a property in Devon, the loan would reduce the value of his London home under IHTA 1984, s 162(4) because it was not used to acquire excluded property.

It should not be overlooked that IHTA 1984, s 162A will also apply to trustees of an excluded property trust.

Example

The trustees of an excluded property trust borrow £1 million secured against UK shares held by them. The £1 million is transferred to an offshore account which is excluded property. The liability will be disallowed.

Exceptions

[2.69] There are situations where a loan used to acquire, maintain or enhance the value of excluded property may be deducted (IHTA 1984, s 162A(2)). It may be deductible where the excluded property has been disposed of (in whole or in part) for full consideration in money or money's worth. The liability will be allowable to the extent that the consideration is now represented by assets that are subject to tax and was not used to finance either the acquisition of other excluded property or their enhancement or maintenance or to discharge any other borrowing which would be disallowable under IHTA 1984, s 162A.

Example

Bobby borrowed £2 million secured on his UK property to purchase a property in St Petersburg. At this stage the loan is not deductible. For family reasons, Bobby sells the St Petersburg property and uses the funds to buy a country home in the UK. The loan would now be deductible because the excluded property has been disposed of and replaced with assets chargeable to UK inheritance tax.

A loan will also be deductible where a property when it was acquired was excluded property, has not been disposed of and is no longer excluded property and is therefore subject to inheritance tax.

Example

> Sophie, who is domiciled in Cyprus, bought a property in Columbia for £500,000 by way of loan. Some years later she became deemed domiciled in the UK under IHTA 1984, s 267 with the result that the Columbian property formed part of her estate for UK inheritance tax purposes. The liability would, on her death, be deductible but only up to the value of the property now chargeable, namely the Columbian property (IHTA 1984, s 162A(3)).

Where the terms of a loan allow interest on the loan to accumulate instead of being repaid with the result that, on death, the liability is greater than the value of the property, a deduction is allowed up to the value of the property only and not on the greater amount.

Where the value of the liability is greater than the value of the asset acquired with the loan and that asset has not been disposed of and remains excluded property, the excess liability may be deducted under IHTA 1984, s 162A(4) provided that the excess was not as a result of one of the following:

(a) arrangements, the main purpose, or one of the main purposes, of which is to secure a tax advantage;
(b) an increase in the amount of the liability (whether due to the accrual of interest or otherwise). An example would be where interest has been added to the initial loan; or
(c) a disposal, in whole or in part, of the property.

Arrangements are defined in IHTA 1984, s 162(8) as 'any scheme, transaction or series of transactions, agreement or understanding, whether or not legally enforceable, and any associated operations'. A tax advantage is 'the avoidance or reduction of a charge to tax, or the avoidance of a possible determination in respect of tax'. Tax in this context means inheritance tax (IHTA 1984, s 272; FA 1986, s 100).

Where borrowed moneys are used to purchase excluded property which subsequently falls in value – for example, because of a move in the markets – the excess may be taken into account and deducted against other assets in the estate.

The restriction will also apply where borrowed funds were used to acquire assets which later become excluded property and have not been disposed of (IHTA 1984, s 162A(5)). The liability may only be taken into account to the extent that its value is greater than the assets acquired with the borrowed funds.

Example

> Alberto is non-UK domiciled and borrowed £2 million to buy some diamond jewellery for £3 million which he kept in the safe in his London property. His wife took the jewellery with her on a trip to the Cannes Film Festival. Whilst she was in Cannes, Alberto died. At the time of his death the diamonds would have been excluded property and so the liability of £2 million is therefore not allowable. If she had taken only half the jewellery, with a value of £1.5 million, a liability of £1 million would have been allowable.

Application of the rules

[2.70] IHTA 1984, s 162A applies to deaths and other chargeable events which occur after 16 July 2013 regardless of when the liability was incurred (FA 2013, Sch 36, para 5).

A liability is treated as having been incurred on the date that the agreement was made (FA 2013, Sch 36, para 5(3)). Where an existing loan agreement is varied, the additional liability is treated as having been incurred on the date that the agreement was varied (FA 2013, Sch 36, para 5(3)(A)). In most cases there will be a written loan agreement but in the event that there is not, HMRC state that the liability will be treated as incurred on the date the money is paid to the borrower (HMRC Inheritance Tax Manual, para 28011).

Acquisition of certain relievable property

Acquisition of assets qualifying for business property relief

[2.71] Where a liability is incurred to acquire assets that qualify for business property relief under IHTA 1984, s 104 or for the maintenance or enhancement of the value of those assets, IHTA 1984, s 162B(2) provides that the liability will be deducted first from the value of the assets qualifying for relief regardless of whether the liability is secured on other assets. Business property relief will be given on the net value of the asset after deduction of the liability. Where the liability has already been taken into account under IHTA 1984, s 110(b), section 162B does not apply.

Example

Brian borrows £300,000 secured against his house which he uses to buy shares in a company in which he is a director which qualify for business property relief. On his death, the shares have increased in value and IHTA 1984, s 162B applies because the liability has been incurred to acquire a relevant business asset. The liability will reduce the value of the shares subject to IHTA 1984, s 175A being met (see **2.76** below) with the excess of the value in the company shares over the liability being reduced by business property relief. In valuing his house on his death the liability will not be taken into account.

Acquisition of assets qualifying for agricultural property relief

[2.72] IHTA 1984, s 162B(3) and (4) are similar to those provisions discussed above in relation to assets qualifying for business property relief. Where borrowed moneys are used directly or indirectly to acquire assets that qualify for agricultural property relief under IHTA 1984, s 116 or to enhance or maintain the value of such assets then the liability will be deducted first from the value of those assets (IHTA 1984, s 162B(4)). Again, this will be the case even where the liability is secured on other assets. Agricultural property relief will then be given on the agricultural value of the asset after deduction of the liability.

Example

> Marjorie borrows £500,000 to purchase some farmland adjoining her farm. On her death the value of her estate is £3 million, of which £1.5 million represents assets qualifying for relief. The liability of £500,000 reduces the agricultural value of the property on which relief is available to £1 million.

In the case where assets are acquired, some of which qualify for agricultural property relief and some of which do not, the apportionment of any loan at the date of death needs to be considered. The Revenue accept that there may be a number of approaches but seem to prefer the method of using the values at the date of acquisition (HMRC Inheritance Tax Manual, para 28021).

There will, of course, be situations where an asset qualifies for both agricultural and business property relief. IHTA 1984, s 114 provides that agricultural property relief applies to the agricultural value first and business property relief applies to any excess value on the agricultural value of the asset. Where the liability exceeds the agricultural value of the asset, there will be no agricultural property relief to be deducted against the estate. The balance of the liability can then be set against the non-agricultural value of the asset to determine the value of the asset which may qualify for business property relief.

Acquisition of assets qualifying for woodlands relief

[2.73] Where moneys are borrowed to acquire land, trees or underwood, to allow the planting of trees or underwood or the maintenance or enhancement of the value of the trees or underwood, the liability will be treated in the same way as discussed above. This is discussed in more detail in CHAPTER 12 WOODLANDS.

Application of the rules

[2.74] The provisions found in IHTA 1984, s 162B apply only to liabilities incurred after 5 April 2013.

Repayment of loans used to finance excluded property or certain relievable property

[2.75] IHTA 1984, s 162C will apply when a loan has been partially repaid. It is only the unpaid balance of the loan which will be affected by the provisions found in IHTA 1984, ss 162A and 162B. The legislation also provides rules as to how repayments should be applied to a liability. The repayment is first applied to any part of the liability that was not attributable to excluded property or relievable property, then to any part used to finance relievable property, and finally to any part used to finance excluded property.

Discharge of liability after death

[2.76] IHTA 1984, s 175A imposes a restriction on the deductibility of liabilities from an estate where the liability is not repaid or discharged out of the estate. Where this is the case it may still be taken into account to reduce the value of the estate to the extent that:

(a) there is a real commercial reason for the liability not being repaid;
(b) the main purpose or one of the main purposes of leaving the liability or part of it undischarged is not to secure a tax advantage;
(c) the liability is not prevented under any other provision of IHTA 1984 from being taken into account (IHTA 1984, s 175A(2)).

All three conditions must be met. In such a case the liability may be allowed as a deduction against the estate even if it is not repaid. IHTA 1984, s 175A(3) provides that there is a real commercial reason for a liability not being discharged where it is shown that:

(a) the liability is to a person dealing at arm's length; or
(b) if the liability were to a person dealing at arm's length, that person would not require the liability to be discharged.

The legislation does not, however, specify the time at which the 'real commercial reason' must exist, nor does it specify whether s 175A(3) is an exhaustive definition or not.

A 'tax advantage' is defined for the purposes of s 175A(2)(b) as:

(a) a relief from tax or increased relief from tax;
(b) a repayment of tax or increased repayment of tax;
(c) the avoidance, reduction or delay of a charge to tax or an assessment to tax; or
(d) the avoidance of a possible assessment to tax or determination in respect of tax.

For these purposes 'tax' includes income tax and capital gains tax whereas IHTA 1984, s 169B only relates to inheritance tax.

It is considered by many that IHTA 1984, s 175A was introduced to frustrate the home loan or double trust scheme. The Revenue in their Guidance at para 28028 state that:

'It is important to note here that whilst the liability may be part of wider arrangements that are aimed at securing a tax advantage, for example, a home loan or double trust scheme, you should only consider whether it is the non-repayment of the liability [that] gives rise to a tax advantage.'

There are specific provisions dealing with the situation where a liability is secured on property which passes to a spouse or civil partner. Where a liability is not taken into account in determining the value of a person's estate, the liability is not to be taken into account in determining the extent which the estate of any spouse or civil partner has increased (IHTA 1984, s 175A(4)).

Example

Jasmine makes a loan of £50,000 to her aunt to make a trip of a lifetime which is secured on her aunt and uncle's £1 million house. The loan is interest-free and repayable on demand. On her aunt's death her uncle is the sole beneficiary of her Will. The loan is not repaid as Jasmine is happy for it to remain outstanding until her uncle's death. The loan would not be left outstanding by an arm's length creditor and so under s 175A(2)(a) it would not be taken into account. As the liability is disallowed the chargeable value of the property is £1 million rather than £950,000. The spouse exemption of £1 million, however, is available.

Where a liability is partially repaid after death, the part repaid will be allowed as a deduction unless the unpaid portion meets the conditions of IHTA 1984, s 175A(2).

Where funds have been used to acquire excluded property, relievable property and other assets and the liability is partially repaid, IHTA 1984, s 175A(7) sets out the priority of allocation against the assets of the estate.

As mentioned above, in order for a liability to be taken into account it must be discharged out of the estate or from excluded property owned by the deceased immediately before his death. This raises the question of what happens in the typical arrangement where a mortgage is repaid using the proceeds of an insurance policy which had been written in trust. The proceeds of the insurance policy fall outside the deceased's estate and therefore if the mortgage is repaid using those moneys the mortgage will not be deducted. If, however, the proceeds of the insurance policy were lent to the estate in order to repay the mortgage, it would seem that HMRC will accept that the liability has been discharged out of the estate (HMRC Inheritance Tax Manual, para 28027).

Application of the rules

[2.77] Section 175A will apply in relation to deaths and other chargeable events that occur after 16 July 2013. These rules may be said, therefore, to have an element of retrospection in as much as they will apply to liabilities incurred before the passing of the Finance Act 2013.

Asset conversion

[2.78] The third basic way in which the inheritance tax payable on a person's death may be mitigated is by asset conversion. An estate comprising a portfolio of gilts and securities quoted on the Stock Exchange and a house worth in total (say) £500,000 will (at 2013/14 rates) suffer on death an inheritance tax charge of £70,000. If, however, that estate had solely comprised property which qualified for 50% agricultural property relief, the value of the estate for inheritance tax purposes would reduce to £250,000 and no tax would be chargeable.

This is an extreme example, but it illustrates the basic principle that in inheritance tax terms it is better for a wealthy client with surplus assets which he is not prepared to give away to invest those assets in commercially sound property which qualifies for some form of relief. The types of property most suitable for this exercise include the following.

(a) *Agricultural property*, tenanted *or untenanted*. See Chapter 11 The Family Farm.

(b) *Woodlands*. Provided the statutory rules are satisfied, full 100% business property relief should apply. Woodlands also have certain capital gains tax advantages for their owner. For a more detailed analysis, see **Chapter 12 Woodlands**.

(c) *Lloyd's underwriting assets*. Business property relief is available on a Lloyds' member's interest in Lloyds, whether the member is an individual, a member of a SLP or LLP or a shareholder in a company (NameCo). An individual member at Lloyd's may qualify for business property relief on his open underwriting years, Lloyd's deposit, his special reserve fund, his general (or personal) reserve and any assets which secure a guarantee or letter of credit issued by a bank up to the amount of the guaranteed sum. The relief will be subject to the overriding constraint that funds eligible for relief cannot be disproportionate to the level of underwriting as a whole. Business property relief is also available on the value of a member's interest in a Lloyd's SLP or LLP, and the ancillary trust fund assets supporting them, and on the value of shares in a NameCo. Since 31 December 2006 business property relief has not been available on external auxiliary trust fund assets supporting a NameCo except to the extent that they also support the unlimited run-off of a converting member. For a more detailed consideration, see **Chapter 16 Making a Will**.

(d) *Unquoted shares or securities in a company*. Rather than an individual trying to source a portfolio of suitable unquoted shares or securities on which business property relief will be available, there are a number of organisations that manage portfolios of suitable shares which qualify for relief in return for a management fee.

(e) *Sleeping partner in unincorporated business*. An individual not wishing to take an active role in a business may consider becoming a sleeping partner of an unincorporated business or a member of a limited liability partnership. Business property relief of 100% will be available.

It must be remembered that in order to qualify for business property relief, agricultural property relief or woodlands relief, the deceased must have satisfied various conditions, relating, for example, to the period of ownership of the assets in question.

The use of loans

[2.79] Before 2013/14 individuals with a surplus of assets which they preferred not to realise and invest (either because they liked the existing investment or because to do so would give rise to a large chargeable gain) would borrow on the security of the non-qualifying assets and invest the borrowings in assets qualifying for relief.

This had the result that the loan would reduce the value of the non-qualifying assets on which the loan was secured and relief would be available on the qualifying assets provided the various conditions were satisfied.

As discussed above, no deduction is given for a loan taken out after 5 April 2013 to finance the acquisition of such assets.

One other device for converting assets not qualifying for relief into assets that do, although one which is extremely rare in practice, concerns shareholdings in publicly quoted companies. A controlling shareholding in a quoted company qualifies for 100% business property relief (IHTA 1984, s 105(1)(b)). A non-controlling holding does not qualify for any relief. If two or more individuals own shareholdings which together (but not separately) give control of a public trading company, they could transfer their shares to a newly formed unlisted holding company in return for shares in that company. The shares in the holding company would then qualify for 100% or 50% business property relief depending upon the size of the holding. Section 105(3) provides that business property relief will not apply to shares in companies whose only or main business is, *inter alia*, making or holding investments. However, under s 105(4)(b) the relief will still apply to the holding company of one or more trading subsidiaries.

It will be appreciated that the scope for the 'asset conversion' type of inheritance tax mitigation will be fairly limited. It is also a device to be used with care.

Asset freezing

[2.80] The fourth way of mitigating inheritance tax is by asset freezing.

Loans

[2.81] The simplest example of an asset freezing measure is making a loan to the persons one wishes to benefit from one's estate. This freezes the value of the debt due to the lender which forms part of the lender's estate; and any capital growth of the assets in which the borrower invests the proceeds of the loan falls outside the lender's estate. To ensure making the loan does not itself give rise to an inheritance tax charge, the loan is usually expressed to be interest free and repayable on demand, so that there is no immediate reduction in the value of the lender's estate.

A loan is a very effective, commonly used estate planning device. It is particularly attractive to moderately wealthy parents with some free capital who wish to help out their children but are reluctant to part completely with a part of their estate. The lender can always write off the loan over a period of time using his annual £3,000 exemption and may write it off completely by way of a potentially exempt transfer, if he later finds that he can do without the capital. (Whilst the loan and the subsequent release will undoubtedly amount to associated operations within IHTA 1984, s 268(1), s 268(3) will operate to prevent there being an overall chargeable transfer.)

Matters to consider

[2.82] Where the borrower uses the proceeds of the loan to purchase an asset which is not readily realisable, or which is only immediately realisable for a lower figure than its cost, and has no other liquid assets available to repay the loan and (for whatever reason) is not in a position to borrow funds commercially to do so, then although the loan is repayable on demand there is a possibility that it will not be repaid and therefore there may be an immediate reduction in the lender's estate.

It is possible that in those circumstances the Revenue may argue that the failure to charge interest represents a waiver of interest and may seek to treat this as a succession of gifts made over the duration of the loan. Such an attempt would be entirely misconceived.

It is sometimes suggested that any income arising from the benefit of the loan in the borrower's hands will form part of the total income of the lender under the income tax settlement rules. This is, however, a difficult argument to sustain because, even if a straightforward loan can be regarded as a 'settlement' for the purposes of ITTOIA 2005, Pt 5 Ch 5, it is necessary first to identify the settled property and then to show that income arises from that property. As the lender is merely exchanging the property lent for a chose in action (namely his rights against the borrower), the settled property can only be either the chose in action, which does not give rise to any income, or the proceeds of the loan in the hands of the borrower in which the lender would seem to have no interest. Nevertheless, the risk of some form of attack from the Revenue clearly exists (for example, see *IRC v Levy* [1982] STC 442, 56 TC 68 (Ch D)). The Revenue may attempt to argue that the loan constitutes part of a wider 'arrangement' that the interest would not be paid. In such circumstances, it may seek to argue that any income earned from the capital lent constitutes assessable income in the hands of the lender. It is unlikely that the Revenue would be successful in such an approach.

Another possible problem is the gifts with reservation provisions, but again it is difficult to see how a straightforward loan (even interest-free) could be regarded as a gift for the purposes of FA 1986, s 102. The Revenue's view on this appears to be that the grant of an interest-free loan repayable on demand is not a transfer of value but it is a gift because there is a clear intention to confer bounty; the property disposed of being the interest foregone (see HMRC Inheritance Tax Manual, para 14317). That view is clearly incorrect. The lender cannot be said to have disposed of property which is the interest arising on the loan because that 'property' has never existed. Nor can the lender be said to have disposed of the income arising on the investment of the money lent because that income has never belonged to the lender.

One also has to consider the pre-owned assets charge under FA 2004, Sch 15 where a lender resides in a property purchased by another with money loaned to him by the lender. The Revenue's view is that it does not regard the contribution condition set out in Sch 15, para 3(3) as being met. It is their view that since the outstanding debt will form part of his estate for IHT purposes, it would not be reasonable to consider that the loan falls within the contribution condition and therefore not reasonably attributable to the consideration, even where the loan was interest free. HMRC say that it follows that the 'lender', in such an arrangement, would not be caught by a charge under Sch 15 (HMRC Inheritance Tax Manual, para 44005).

The loan may be made either to an individual or to a trust. However, great care is required where a loan is made by a settlor and the trustees invest in income-producing assets. Any repayment of the loan to the lender may give rise to an income tax liability under ITTOIA 2005, s 633. This is broadly to the extent of the amount repaid if the trustees then, or in the future, have any undistributed income.

Where there is a privileged trust with a life tenant and one or more remaindermen, an on-demand loan by the trustees to the remaindermen of assets in the trust fund will effectively freeze the value of those assets in the estate of the life tenant. It may be advisable to charge a modest level of interest on the loan as a means of countering the argument that there has been a partial termination of the life tenant's interest in possession.

Release of the loan

[2.83] As mentioned above a loan can be written off over a period of time taking advantage of the annual exemption and also the potentially exempt transfer provisions.

Where no consideration is given for the release of a loan, the release can only be effected by deed. For a deed to be validly executed, the intention that the instrument is a deed must be made clear in the document. The instrument must either be signed by the person making it in the presence of a witness or be signed at the direction of the person making it in the presence of two witnesses.

Sales of assets

[2.84] A sale is another, but less obvious, type of asset freezing measure. If a father sells his cottage in the country to his son at full market value, any future growth in value will accrue for the benefit of the son. If the father goes on to spend the sale proceeds over a period of time, rather than to retain and invest them, then so much the better as he is reducing his own estate as well. Should the father wish to continue to occupy the property, then the gifts with reservation provisions will not be a problem as the disposal of the cottage will have been by way of a sale for full consideration rather than by way of a gift. Care will need to be taken to ensure the sale of the property to the son is a transaction such as might be expected to be made at arm's length between unconnected parties if the father is to avoid a charge to income tax under the pre-owned assets regime. The disadvantage of the sale is that it could give rise to a capital gains tax charge for the father and also to a stamp duty land tax liability for the son.

Grants of option to purchase

[2.85] Another example of an asset freezing arrangement is the grant of an option to purchase property at its market value at the date of the grant. On the exercise of the option any increase in value in the property will flow through to the grantee free of inheritance tax. The grant of the option must be made for full consideration, otherwise the existence of the option will not be fully taken into account when valuing the property in the grantor's estate on his death or on an exercise of the option (IHTA 1984, s 163).

The grant of an option for consideration will be treated as a disposal of a chargeable asset (with a nil base cost) for capital gains tax purposes and may give rise to a chargeable gain (TCGA 1992, s 144(1)). A gain may arise on the exercise by reference to the unencumbered value of the asset where the parties are connected (TCGA 1992, s 18(7)). In addition, a stamp duty land tax charge may arise on the grant of the option. It should also be borne in mind that options over land are only valid for a period of 21 years (Perpetuities and Accumulations Act 1964, s 9(2)).

The grant should not be a gift with reservation for inheritance tax purposes because no benefit is received by the transferor from the subject matter of the gift (the option) nor does he receive any collateral benefit referable to the gift.

If an option is allowed to lapse without being exercised, this may result in a transfer of value for inheritance tax purposes (IHTA 1984, s 3(3)) which is not capable of constituting a potentially exempt transfer (IHTA 1984, s 3A(6)).

Other arrangements

[2.86] There are other more sophisticated types of asset freezing arrangement. Those involving companies and partnerships are dealt with in more detail in Chapter 10 The Family Business. One such arrangement for a company (now usually an investment company) involves the creation of two classes of shares, one of which receives the present value of the company on a winding-up, which is retained by the original shareholders, and the other of which carries the excess value, which is given away. There is a similar arrangement involving the issue of deferred shares which is also dealt with in more detail in Chapter 10.

So far as partnerships are concerned, it is often the case that the entitlement of a retiring or deceased partner will be limited to the balance on his capital account plus his pro rata share of accrued profits. The effect of this is that any underlying growth in value of the partnership assets accrue for the benefit of the continuing partners, who will often be members of the next generation in a family.

Various insurance companies offer products designed to freeze the value of an estate at a given time. These products involve an individual making a capital investment which is treated as a potentially exempt transfer. The capital is invested in a single premium bond which consists of a capital fund and an income fund. The income fund provides an income from an endowment policy which if it is 5% or less will be free from higher rate income tax. For a more detailed explanation see Chapter 7 Insurance.

Conversion of capital assets

[2.87] The fifth basic method by which the inheritance tax payable on death may be mitigated is by the conversion of capital assets into income producing assets.

Where an individual has capital which he no longer requires or needs he may consider purchasing assets which produce income only for a given period of time. For example, income shares of a split capital investment trust which confer rights to receive dividends but not to assets on a winding up. As the pre-determined winding-up date approaches the market value of the income share decreases. Thus, the investor receives a stream of large income payments (which he uses for his living expenses) matched by a decrease in the capital value of his investments which reduces the inheritance tax liability on his estate.

This method now has a very limited application with the additional rate of income tax being 45% and inheritance tax and capital gains tax being at the lower rates of 40% and 18% or 28% respectively.

Organisation of an estate

General

[2.88] The last topic to consider is the best way of organising an estate with a view to facilitating an easy and cost-effective administration after death. This aspect of estate planning should be kept in mind throughout the individual's lifetime and the following is a list of relevant points all of which are further considered in CHAPTER 16 MAKING A WILL.

Jointly held property

[2.89] Spouses and indeed unmarried individuals living together often hold property jointly either as beneficial joint tenants or as tenants in common. Where property is held as joint tenants, each joint tenant is entitled to the whole of the asset in equal shares and, on death, the deceased's share of the property automatically passes by survivorship to the surviving joint tenant. Under a tenancy in common, each joint owner owns a separate and distinct although undivided share of the property which on their death passes under the terms of their Will or intestacy. Where property is held jointly, it is common (particularly in relation to land) for there to be an express declaration of trust, although there are some situations where there is no such express declaration and so the court has to determine whether, on the facts, there is a constructive trust. Where a property is held by tenants in common it is usual for a declaration of trust to provide for the shares in which the property is held. Holding assets as joint tenants allows the assets to pass to the survivor automatically on the first death without the delay and expense of the personal representatives of the deceased having to transfer them to the survivor. Of course,

the tax implications of holding property jointly during a person's lifetime need to be considered. The general rule is that in relation to income arising on joint property, tenants in common are entitled to the income in proportion to their capital entitlement and joint tenants are entitled in proportion to the number of joint tenants. There are, however, a number of exceptions to this rule. For tax purposes, there is a presumption that spouses and civil partners are beneficially entitled to income arising from jointly owned property in equal shares (ITA 2007, s 836). Yet there are certain types of income which are excluded from this rule (s 836(3)). Where spouses or civil partners are beneficially entitled to income in unequal shares which correspond to their beneficial interests in the property from which it arises, spouses can give a joint declaration to HMRC. Notice may only be given within 60 days of the interest beginning (ITA 2007, s 837). Where there is to be an equal entitlement, this should be evidenced in writing as it is the Revenue's practice to request this evidence (Trusts and Settlements Estates Manual, para 9851).

Legislation provides that where spouses die in circumstances rendering it uncertain which of them survives the other, they will be deemed to die in order of seniority (Law of Property Act 1925, s 184). This rule does not, however, apply in relation to property in Scotland. Whilst it is sensible for certain property to be held jointly, there may be a number of good reasons for vesting assets in the sole name of one of the spouses; for example, where the other is a sole trader or partner in a trading partnership.

Joint bank accounts

[2.90] Joint bank accounts, whilst practical, can cause difficulties in two areas: first, in determining the deceased's interest in the account on death, and second, in identifying the owner who has made a gift from the account. In *Matthews v HMRC* [2012] TC 2329 the deceased transferred money into an account held jointly with her son. HMRC claimed that the entire account was taxable under IHTA 1984, s 5(2) because the deceased had a power to appoint or dispose of the property as she saw fit. A reference was made to the comment made obiter in *Melville v HMRC* [2011] EWCA Civ 1247 which recognised that there was the potential for double taxation on joint bank accounts where any holder can draw on the account so that the account is taxable on the death of each holder. In *Matthews*, the First-Tier Tribunal held that the entire sum was taxable under s 5(2) and that the gift with reservation rules applied. HMRC in their Inheritance Tax Manual at para 15042 state that it is not their practice to tax 'a share of the account that is greater than the share provided by the joint owner'; this is not a statement of law but of practice and so care should be taken when relying upon it.

There is no doubt that the application of inheritance tax to bank accounts 'can be particularly difficult' and so it is recommended that where there are joint bank accounts, a declaration is made as to the parties' intentions and details of the deposits and payments are kept.

The income tax consequences of joint bank accounts should be considered, as the case of *Bingham v Revenue and Customs Comrs* [2013] UKFTT 110 (TC), [2013] SFTD 689 illustrates. In that case, a father had transferred money into a bank account held jointly with his children and wife. The interest arising was apportioned between his wife and children. HMRC argued that the father was assessable on all the interest arising, on the basis that there was a presumption of a resulting trust and in any event the settlement provisions applied so that the income was assessable on him as the settlor.

Foreign assets

[2.91] It is a costly procedure to register a UK grant of probate, or to take out a fresh grant, in a foreign jurisdiction in order to obtain title to foreign stocks and shares. Small holdings should therefore be liquidated if possible before death. If an individual makes investments abroad, either they should be registered in the name of a UK nominee company, which will avoid the need for a foreign grant, or he should be encouraged to consider indirect investment through a UK unit trust or investment company. The same problems will be encountered with a foreign holiday home and again can often be avoided by holding the property in the name of a nominee (which could be a UK incorporated limited company specially set up by the client for the purpose). See also **Chapter 18 UK Domiciliaries Investing Abroad** for more on this aspect.

Life policies

[2.92] These should be inspected to see whether the proceeds are payable to the insured's estate or are held in trust. If the former, then unless the insured leaves the proceeds to his spouse and the spouse survives the insured, they will give rise to an inheritance tax charge on his death. Where the proceeds are intended for the spouse and/or children, the benefit of the policy should be put in trust for them during the insured's lifetime. New policies should similarly be settled on trust from the outset. The additional advantage of the trust is that the policy proceeds may be paid out immediately following the death (on production of the death certificate) without the need to wait for a grant. See also **Chapter 7 Insurance** for more on this aspect.

Pensions

[2.93] Where the individual has a right of nomination over a lump sum death benefit payable under a pension scheme, he should be sure to exercise the right to avoid the benefit falling into his estate on death and possibly being charged to inheritance tax. Where the benefit is payable under a discretionary trust, then he should make sure that the trustees are aware of his wishes as to their ultimate destination.

These lump sum death benefits can provide useful estate planning opportunities in that by directing the lump sums to his children and leaving his wife to inherit his free estate, an individual may leave all members of his family well provided for on his death without incurring any inheritance tax charge. Reference should also be made to **Chapter 8 Pensions** for more on this aspect.

Accident/death in service policies

[2.94] Similar considerations apply here. Where the individual has a right of nomination over the proceeds or may express wishes to trustees as to their destination, he should be sure to do so.

The will

[2.95] No client should ever die intestate. Not only is it usually more costly and more time consuming to obtain a grant of letters of administration rather than a grant of probate but also the trusts which can arise under the intestacy rules can be very costly to administer and they are unlikely to reflect the client's true wishes regarding the devolution of his estate. The statutory intestacy rules are found at **16.3**.