

INHERITANCE TAX ON DISPOSALS OF INTERESTS IN SETTLEMENTS POST FINANCE ACT 2002

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1 Scope of Article

In this article, I consider the Inheritance Tax consequences of disposals of interests in settlements. The matter has been enormously complicated by the enactment of Finance Act 2002, section 119, aimed, ineptly, at nullifying strategies of the type which were held to be inheritance tax effective in *Melville v Inland Revenue Commissioners* [2001] EWCA Civ 1247 [2001] STC and which were designed at obtaining holdover relief from capital gains tax on gifts in settlement.

I also consider traps and possible tax planning opportunities opened up by section 119.

I do not in this article consider the capital gains tax treatment of disposals of interests under settlements, which is extremely complex. The reader is referred to my *Non-Resident Trusts* 8th edition Chapter 15.

2 Pre Finance Act 2002 Considerations

2.1 Disposal of interest in possession

2.1.1 The Basic Rule

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If the interest sold is an interest in possession, tax will normally be charged as if the vendor had made a transfer of value. Inheritance Tax Act 1984, section 51(1) provides:

“51 Disposal of interest in possession

(1) Where a person beneficially entitled to an interest in possession in settled property disposes of his interest the disposal –

(a) is not a transfer of value, but

(b) shall be treated for the purposes of this Chapter as the coming to an end of his interest;

and tax shall be charged accordingly under section 52 below.”

Section 52(1) and (2) provides:

“52 Charge on termination of interest in possession

(1) Where at any time during the life of a person beneficially entitled to an interest in possession in settled property his interest comes to an end, tax shall be charged, subject to section 53 below, as if at that time he had made a transfer of value and the value transferred had been equal to the value of the property in which his interest subsisted.

(2) If the interest comes to an end by being disposed of by the person beneficially entitled to it and the disposal is for a consideration in money or money's worth, tax shall be chargeable under this section as if the value of the property in which the interest subsisted were reduced by the amount of the consideration; but in determining that amount the value of a reversionary interest in the property or of any interest in other property comprised in the same settlement shall be left out of account.”

Hence, tax will normally be charged as if the vendor had made a transfer of value and the value transferred were the difference between the price paid for the interest and the value of the underlying settled property in which it subsisted. Given that before the sale the vendor is deemed to be beneficially entitled to the settled property, the amount on which tax is charged will correspond roughly to the

diminution in value of his estate.²

The most significant feature of these provisions is that if the interest is sold for a fair price, that will still *prima facie* give rise to a deemed transfer of value. The only advantage of a purchase over a gift is that, the greater the price paid, the less the hypothetical transfer of value.

Section 10 (dispositions not intended to confer gratuitous benefit) will not be in point as that applies only in determining whether there is a transfer of value and section 52(1) directs tax to be charged on the hypothesis that one has been made. While section 52 charges tax on the basis of a hypothetical transfer of value, that transfer of value is not deemed to be a chargeable transfer. Hence, there is nothing to prevent it being exempt or potentially exempt, provided the wording of the exempting provision in question is apt to cover the situation.³

If one is ascertaining whether an actual transfer of value has been made by an individual, one ignores the value of excluded property so far as it ceases to form part of a person's estate as a result of a disposition: Inheritance Tax Act, section 3(2). As section 52(1) directs one to proceed on the basis of a hypothetical transfer of value and specifies the hypothetical value transferred, a specific provision, section 53(1), is required to take excluded property out of the section 52 charge.

2.1.2 Position of Purchaser

2.1.2.1 Purchase at Over-value

One can prevent a tax charge under section 52(1) by the purchaser paying more than full value for the interest, namely a price equal to the value of the underlying settled property. That will involve a diminution in the actual estate of the purchaser. Can one argue that there is no diminution as section 49(1) will deem the purchaser to be entitled to the settled property itself? This strategy has been blocked by section 49(2). Section 49 provides:

“49 Treatment of interests in possession

(1) A person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as beneficially entitled

² I say “roughly”, because any diminution in value of the part of his estate which is not referable to the settled property will not be brought into charge to tax.

³ Inheritance Tax Act 1984, section 56 makes special provision in relation to exempt transfers.

to the property in which the interest subsists.

(2) Where a person becomes entitled to an interest in possession in settled property as a result of a disposition for a consideration in money or money's worth, any question whether and to what extent the giving of the consideration is a transfer of value or chargeable transfer shall be determined without regard to subsection (1) above."

Suppose the settled property is worth £1,000,000 and A buys an interest in possession in it worth £500,000. If he pays any more than £500,000, he will *prima facie* have made a transfer of value of the excess. If, for example, he pays £1,000,000, he cannot claim that he has made no transfer of value as he is deemed, by section 49(1), to have become entitled to the settled property itself.

Of course, the person buying the interest in possession may not necessarily make a transfer of value. For example, he may be a non-UK domiciliary and pay the price in non-excluded property. Yet, while a purchase at an over-value would solve the immediate problem, the estate of the vendor would not be reduced in value for inheritance tax purposes. In the unusual case where the settled property did not constitute excluded property but neither the vendor nor the purchaser were United Kingdom domiciled (nor deemed United Kingdom domiciled for inheritance tax purposes) and the sale brought the settlement to an end, then this could be a very useful strategy.

2.1.2.2 Reversionary Interest as Consideration for Interest in Possession

A reversionary interest will often constitute excluded property. Therefore, if a person exchanges such an interest for an interest in possession, he could pay over the odds for that interest, thereby reducing or eliminating the transfer of value deemed to be made by the vendor. Consider the following example. Suppose that settled property, which is held on trust for A for life remainder to B, consists of Fund X and Fund Y. By way of bargain at arm's length, A exchanges his life interest in Fund X in return for B's remainder interest in Fund Y. Let it be assumed that B's interest is excluded property, i.e. none of the exceptions apply. B will therefore make no transfer of value: see section 53(2). There is no problem with Fund Y, as A becomes absolutely entitled to it. As regards Fund X, A is *prima facie* deemed to make a transfer of value under section 52(1), the value transferred being the underlying value of Fund X. Can B claim that he has given consideration consisting of a reversionary interest in Fund Y? No, because section 52(2) expressly excludes it. There are, however, other possibilities which section 52(2) does not expressly exclude but rather implies that they are effective.

2.1.3 Summary

Disposal of Interest for Less than Full Value

Tax charged on hypothetical transfer of value by vendor, borne by settled property.

No tax consequence for purchaser.

Disposal of Interest for Fair Value

Tax charged on hypothetical transfer of value by vendor, borne by settled property.
Value transferred reduced by amount of consideration.

No tax consequence for purchaser.

Disposal of Interest for More than Full Value

Tax charged on hypothetical transfer of value by vendor, borne by settled property.
Value transferred reduced by amount of consideration, potentially to zero.

The purchaser will in principle make a transfer of value as to the element of over-value.

2.2 Disposal of Reversionary Interest

2.2.1 The Basic Position

If the interest disposed of is a reversionary interest, ⁴ the position is more straightforward in that section 52 has no application. There is, however, a trap where Inheritance Tax Act, section 55 (Reversionary interest acquired by beneficiary) applies. It provides:

“(1) Notwithstanding section 5(1) above, where a person entitled to an interest (whether in possession or not) in any settled property acquires a reversionary interest expectant (whether immediately or not) on that interest, the reversionary interest is not part of his estate for the purposes of

⁴ Section 47 (Reversionary interest) provides: “In this Act ‘reversionary interest’ means a future interest under a settlement, whether it is vested or contingent (including an interest expectant on the termination of an interest in possession which, by virtue of section 50 below, is treated as subsisting in part of any property) ...”.

this Act.

(2) Section 10(1) [dispositions not intended to confer gratuitous benefit] above shall not apply to a disposition by which a reversionary interest is acquired in the circumstances mentioned in subsection (1) above.”

In the case where the purchaser is entitled to an interest in possession, then even if he paid fair market value for the reversionary interest, his estate would be diminished in value by the amount paid, so that he would *prima facie* make a transfer of value. For he is deemed to be entitled to the settled property both before and after the purchase. Section 10(1) would, if its application were not excluded, normally prevent that from being a transfer of value.

It is questionable whether the wording of section 55 is entirely apt. Suppose that settled property is held on trust for A for life, remainder to B absolutely. Suppose that A and B issue a direction to the trustees of the settlement under *Saunders v Vautier*, that the trustees shall henceforth hold the property on trust for A absolutely, is it the case that A “acquires a reversionary interest expectant” on his life interest? From a technical perspective he has not. The whole point of the exercise is that the reversionary interest has ceased to exist. Hence, the payment by A to B of fair value for his remainder would not be caught by section 55 and ought not to rank as a transfer of value on account of section 10. The result is that A’s estate would be diminished in value for inheritance tax purposes without any transfer of value being made by him.

2.2.2 Summary

Sale at Undervalue

Vendor makes no transfer of value provided reversionary interest is excluded property.

Purchaser will not make a transfer of value unless section 55(1) applies or, arguably, even if section 55(1) does not apply, if he is entitled for an interest in possession to the same property in which the reversionary interest subsists.

Sale at Fair Value

Vendor makes no transfer of value.

Purchaser will not make a transfer of value unless section 55(1) applies or, arguably, even if section 55(1) does not apply, if he is entitled for an interest in possession to

the same property in which the reversionary interest subsists.

Sale for More than Full Value

The purchaser will *prima facie* make a transfer of value. The value transferred will *prima facie* be the difference between (a) the extent to which his estate is increased in value by the acquisition of the reversionary interest and (b) the amount paid for it. If section 55 applies, it will *prima facie* be the whole of the amount paid.

The vendor will not make any transfer of value.

2.3 Disposal of Interest neither in Possession nor in Reversion

The treatment of these interests is straightforward as there are no special provisions applicable to them.

Disposal for less than Full Consideration

A gift or sale at a deliberate under-value would *prima facie* constitute a transfer of value on the part of the vendor.

The purchaser will not make any transfer of value or deemed transfer of value unless section 55 is in point, which in my view is unlikely ever to be the case.

Disposal for Fair Value

There will be no transfer of value on the part of the vendor.

The purchaser will not make any transfer of value or deemed transfer of value unless section 55 is in point, which in my view is unlikely ever to be the case.

Disposal of Interest for More than Full Value

A purchase at a deliberate over-value would *prima facie* constitute a transfer of value on the part of the purchaser.

The vendor will not normally make any transfer of value.

2.4. Acquisitions of Reversionary Interests

Most reversionary interests will constitute excluded property. If a reversionary interest is purchased, it will not be excluded property in the hands of the purchaser:

Inheritance Tax Act 1984, section 48(1)(a).

3 Impact of Finance Act 2002, Section 119

3.1 The New Law

Finance Act 2002, section 119 has inserted into the Inheritance Tax Act a new section 55A (Purchased settlement powers), which provides:

“55A Purchased settlement powers.

- (1) Where a person makes a disposition by which he acquires a settlement power for consideration in money or money's worth –
 - (a) section 10(1) above shall not apply to the disposition;
 - (b) the person shall be taken for the purposes of this Act to make a transfer of value;
 - (c) the value transferred shall be determined without bringing into account the value of anything which the person acquires by the disposition; and
 - (d) sections 18 and 23 to 27 above shall not apply in relation to that transfer of value.
- (2) For the purposes of this section, a person acquires a settlement power if he becomes entitled –
 - (a) to a settlement power,
 - (b) to exercise, or to secure or prevent the exercise of, a settlement power (whether directly or indirectly),
 - (c) to restrict, or to secure a restriction on, the exercise of a settlement power (whether directly or indirectly),

as a result of transactions which include a disposition

(whether to him or another) of a settlement power or of any power of a kind described in paragraph (b) or (c) above which is exercisable in relation to a settlement power.”

“Settlement power” is defined by Inheritance Tax Act, section 47A (Settlement power), also inserted by Finance Act 2002, section 199, which provides:

“In this Act, ‘settlement power’ means any power over, or exercisable (whether directly or indirectly) in relation to, settled property or a settlement.”

This is very wide indeed. It would include a special or general power of appointment, including a power to revoke a settlement. It would also include a power to appoint or remove trustees or a protector or appointor.

Sections 47A and 55A were themselves inserted consequent on the amendment of the definition of “property” in Inheritance Tax Act, section 272. That definition now reads “‘property’ includes rights and interests of any description *but does not include a settlement power*”. (The words I have italicised were added by Finance Act 2002, section 119(4).)

The amendment of that definition is the Capital Taxes Office’s (completely inept) response to the decision of the Court of Appeal in *Melville v Inland Revenue Commissioners* [2001] EWCA Civ 1247 [2001] STC 1271 that where a person has the right to revoke a settlement and vest the settled property in himself, then that right forms part of his estate for inheritance tax purposes. Instead of tackling *Melville* strategies in an appropriate way,⁵ all “settlement powers” have been removed from a person’s estate.

The changes effected by section 119 have effect in relation to transfers of value on or after 17th April 2002. In effect, therefore, if a person was entitled to a settlement power immediately before that date, his estate was on that date reduced in value for inheritance tax purposes. That reduction in value is not, however, a transfer of value.

3.2 Purchases of Settlement Powers

That *prima facie* opens up scope for considerable inheritance tax planning. One method of planning would be for a person to enter into a bargain at arm’s length whereby he exchanged part of his estate for a settlement power. But for the new

⁵ They were aimed at secure holdover relief from capital gains tax on a gift into settlement.

section 55A, that would involve a reduction in the value of his estate for inheritance tax purposes (without necessarily any corresponding reduction in reality) but would not involve any transfer of value on his part.

Hence, section 55A goes into overkill. It applies were a person makes a disposition by which he acquires a settlement power for consideration in money or money's worth. We are told that the person is to be deemed to make a transfer of value, that section 10(1) (no intent to confer gratuitous benefit) is not to apply to the disposition, that the value transferred is to be determined without bringing into account the value of anything which the person acquires by the disposition and that sections 18 and 23 to 27 (various exemptions) are not to apply in relation to that transfer of value.⁶

Thus, if I acquire by purchase the right to vest trust property in myself, that right will not form part of my estate. My estate will, when I enter into the purchase, diminish in value by the amount of the price. While I cannot claim that I had no intention of conferring a gratuitous benefit on the vendor or that the transfer of value is exempt, e.g. because the vendor is a charity, there is nothing to prevent me from claiming that the transfer is a potentially exempt transfer, e.g. because I purchased the power from an individual.

There is no question of the transfer of value being exempt under Inheritance Tax Act 1984, section 10 on the grounds that it was a disposition not intended to confer gratuitous benefit on any person. Nor is there any question of any exemption (other than the annual exemption) being available.

The problem can be alleviated if the vendor is an individual. While the purchaser would still make a transfer of value, it would be a potentially exempt one and thus would have no inheritance tax consequences provided he survived for seven years. In certain circumstances, e.g. where seven-year decreasing term assurance on the life of the purchaser could be obtained at a modest premium, this would be acceptable. In other cases, however, such as death-bed inheritance tax schemes, it clearly would not.

It will often be the case that a settlement power is acquired along with a beneficial interest. For example, if settled property is held on trust for A for life, remainder to B, the trust being governed by English law, and Z buys the life interest for fair value, Z will acquire a settlement power in that he will become entitled to restrict

⁶ The annual, small gifts and normal expenditure out of income exemptions can still in principle apply. It is probable that these were not excluded as it was thought they posed no threat to the Revenue.

the exercise of a settlement power, namely the power conferred on the trustees by section 32, Trustee Act 1925 to advance B: see section 55A(2)(c).

In calculating the transfer of value which section 55A deems Z to make, does one ignore the life interest received by him? Reading the section literally, one does. For Z makes only one disposition, namely the payment of cash, and section 55A(1)(c) directs one to ignore "anything" which he acquires as the result of the disposition. Hence, Z appears to make a transfer of value of the entire purchase price paid.

Will purposive construction help? In my experience, the courts are much more ready to use purposive construction to help the Revenue than the taxpayer.

3.3 Gifts which do not Increase Donee's Estate

Now it will be readily apparent that a person who wishes to make a gift to another can do so without any increase in the value of the estate of the donee for inheritance tax purposes. The donor should set up a settlement under which the donee has no fixed interest of any value and does not have an interest in possession. The donee is given, however, a power to appoint the settled property (or income) to himself. In terms of planning for the next generation, section 119 is quite useful, although, even before it was enacted, one could achieve almost the same result by giving the donee a similar power of appointment exercisable with the consent of another person.

3.4 Reduction of Value of Own Estate

Is it possible to reduce the value of one's own estate while still retaining the right to benefit? For example, can one create a trust under which one has no interest except a power to appoint capital to oneself? One will *prima facie* make a transfer of value, although that transfer might be exempt or potentially exempt or the value transferred might be reduced to nil by 100% business or agricultural property relief. It is even possible to construct a settlement under which it would be possible to argue that there was no transfer of value on account of Inheritance Act 1984, section 10.

The real question will usually be whether the gifts with reservation of benefit provisions will bite.

Let us assume that the gift is not of an interest in land, so that the only provision in point is Finance Act 1986, section 102, which provides:

“(1) ... this section applies where ... an individual disposes of any property by way of gift and either –

(a) possession and enjoyment of the property is not *bona fide* assumed by the donee at or before the beginning of the relevant period; or

(b) 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 ...”

In order for the section to apply, it is not necessary that there is anything comprised in the donor's estate corresponding to the reservation of benefit. Hence the amendment to the Inheritance Tax Act, section 272 definition of “property” does not *automatically* exclude the application of section 102.

Would there, in the circumstances hypothesised, have been a reservation of benefit before 2002? It was arguable that, in so far as the power was not exercised, there was not and that in so far as the power was exercised to vest capital in the settlor, that capital would then be part of his estate in any event. Of course, the question would often have been academic, given that the power of revocation would have been a valuable asset of the settlor's estate.⁷

The decision of Lightman J in *IRC v Eversden* [2002] EWHC 1360 (Ch) [2002] STC that there is a gift with reservation of benefit where the settlor of a trust is a discretionary beneficiary of it, is clearly not helpful.

If the gift is one of an interest in land, Finance Act 1986, section 102A could apply if the donor or his spouse “enjoys a significant right or interest, or is party to a significant arrangement, in relation to the land”. A right, interest or arrangement in relation to land is significant for the purposes of subsection (2) above if (and only if) it entitles or enables the donor to occupy all or part of the land, or to enjoy some right in relation to all or part of the land, otherwise than for full consideration in money or money's worth.

If section 102A does not cause there to be a gift with reservation of benefit, that does not stop section 102 applying. It is arguable, however, that if section 102B

⁷ There would be circumstances in which the question would be far from academic. For example, if the exercise of the power of revocation would involve the trustees realising a chargeable gain and being liable to capital gains tax, the right of revocation would be worth less than the settled property itself.

applies but does not cause there to be a reservation of benefit, then neither section 102 nor section 102A will apply. Section 102B “applies” where an individual disposes by way of gift of an undivided share of an interest in land. There is no property subject to a reservation where, for example, the donor does not occupy the land.