The Personal Tax Planning Review

HOLDOVER RELIEF ON DISPOSALS OF INTERESTS IN SETTLEMENTS

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1 Chargeable and Exempt Disposals

1.1 General Exemption

The trustees of a settlement are treated for capital gains tax purposes as a separate body owning the settled property and liable to capital gains tax on deemed disposals of such property.[2] Hence, the beneficial interests in the settled property are technically separate rights capable of independent disposal. It is thought unjust to tax the beneficiaries on a disposal of their beneficial interests, as this would give rise to a double charge to tax on the same underlying gain. This principle is given effect to by Taxation of Chargeable Gains Act 1992 section 76(1).

1.2 Interests Directly Acquired for a Monetary Consideration

Until 6th March 1998, there were only three important exceptions to the general rule that disposals by beneficiaries of their beneficial interests under a settlement do not give rise to chargeable gains. Firstly, where the person making the disposal ("the disponor") acquired his interest for a consideration in money or money's worth, unless the interest was created for his benefit by the terms of the settlement: Taxation of Chargeable Gains Act 1992 section 76(1).

The expression “a consideration in money or money’s worth” includes all consideration in the common law sense except the consideration of marriage. The exclusion of transfers for a consideration consisting of another interest under the

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2 Taxation of Chargeable Gains Act 1992 section 69(1)

beneficiaries' immunity from capital gains tax on the disposal of their beneficial interests.

1.3 Interests Previously Acquired for a Monetary Consideration

Secondly, where the disponor acquired his interest (whether or not for a consideration) from a person who had acquired his interest for a consideration in money or money's worth (whether or not the interest was created for the benefit of the predecessor in title by the terms of the settlement): Taxation of Chargeable Gains Act 1992 section 76(1).

1.4 Interest in Non-UK Resident Settlements

The third exception is where the disposal is of an interest in a non-UK resident settlement (other than the disposal a person is deemed to make by virtue of Taxation of Chargeable Gains Act 1992 section 76(2) when he becomes absolutely entitled to settled property): Taxation of Chargeable Gains Act 1992 section 85(1).

1.5 Interests in Previously Non-UK Resident Settlement

Finance Act 1998 amended Taxation of Chargeable Gains Act 1992 section 76, with effect from 6th March 1998, by the insertion of another exception, contained in a new subsection (1A):

> " (1A) Subject to subsection (3) below, subsection (1) above does not apply if:
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> (a) the settlement falls within subsection (1B) below; or
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> (b) the property comprised in the settlement is or includes property deriving directly or indirectly from a settlement falling within that subsection.
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> (1B) A settlement falls within this subsection if there has been a time when the trustees of that settlement:
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> (a) were not resident or ordinarily resident in the United Kingdom; or
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> (b) fell to be regarded for the purposes of any double taxation relief arrangements as resident in a territory outside the United Kingdom."

Subsection (3) provides that subsection (1A) is not to prevent subsection (1) above from applying where the disposal in question is a disposal in consideration of obtaining settled property that is treated as made under section 76(2), i.e. on a person becoming absolutely entitled to settled property as against the trustees.

The aim was to prevent the strategy whereby the trustees of a non-UK resident settlement not caught by the Offshore Settlor Provisions[3] reduced the trust assets to cash or non-chargeable assets and in the next year of assessment immigrated into the United Kingdom. Beneficiaries would then sell to non-UK residents interests under the settlement which would in all probability entitle the purchasers to trust capital within a relatively short period. Trust gains under the Offshore Beneficiary Provisions[4] would, it was thought, be visited solely on the purchasers who, being non-UK resident would not be liable to capital gains tax. The reaction entails a great deal of overkill.

The exception would appear to cover a trust which is at the date of the disposal non-UK resident, as there will always have been a time, when it was not UK resident.

1.6 Taxation of Chargeable Gains Act 1992 Schedule 4A Exemption

Schedule 4A was introduced into the Taxation of Chargeable Gains Act 1992 by Finance Act 2000 with effect from 21st March 2000.[5] It is headed "Disposal of Interest in Settled Property: Deemed Disposal of Underlying Assets". Its purpose is to drive further nails into the coffin of a scheme which had been largely closed by restrictions on holdover relief announced in the November 1999 mini-budget.[6] Where there is a disposal of an interest in certain settlements for value, the trustees are deemed to dispose of and reacquire the (relevant part of the) settled property for a market value consideration. While the Schedule normally applies only to United Kingdom resident trusts, it can apply to trusts which are non-UK resident but have been United Kingdom resident in the past.

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3 See my *Non-Resident Trusts* 8th edition Chapter 13.

4 See my *Non-Resident Trusts* 8th edition Chapter 14.

5 See my *Non-Resident Trusts* 8th edition 12A.2 and my article *Disposals of Interests in Settled Property: TCGA 1992 Schedule 4A* in this issue of this Review.

6 See my articles *United Kingdom Mini-Budget Anti-Avoidance Measures* in *The Offshore and International Taxation Review* Volume 9 Issue 2 and *UK Finance Bill and Tax Planning for Offshore Trusts* (especially sections 3 and 4) in *The Offshore and International Taxation Review* Volume 9 Issue 3.

Paragraph 10 of the Schedule is headed "Avoidance of double-counting". No chargeable gain is treated as accruing on the disposal of the interest in the settlement provided that the chargeable gain on the disposal of the interest would be less than the net chargeable gain on the deemed disposal by the trustees.

2 The Rise and Fall of Holdover Relief

A person who gifts an asset makes no real gain at all: he sustains a loss. Yet, paradoxically, for capital gains tax purposes he is in general deemed to dispose of the asset for a consideration equal to its market value. Over the years, derogations were made from the principle by the introduction of holdover relief on a piecemeal basis. Under Mrs Thatcher a general holdover relief was introduced for disposals between individuals and/or trustees of settlements. The only real limitation on the relief was that the donee or beneficiary must be resident or ordinarily resident in the UK. As from the 1989 Budget Speech, general hold-over relief was abolished and it is now available only in certain specified circumstances, which were reduced still further by Finance Act 2000.[7]

Since the Finance Act 1989 changes to hold-over relief, it is a moot point precisely when the relief is available in respect of the gift of an interest in a settlement (whether or not UK resident) to a UK resident (whether an individual or the trustees of a settlement). The draftsman of the provisions clearly did not have such cases in mind. There may well be situations, therefore, where the disposal of an interest in settled property would not qualify even though a disposal of the settled property itself would.

3 Planning

Holdover relief would obviously be useful in any case where a gift or disposal at an undervalue of an interest in a settlement would otherwise result in a taxable gain being realised or in a trust gain being generated for the purposes of the Offshore Beneficiary Provisions. It would be particularly useful where a beneficiary is about to become absolutely entitled to settled property comprised in a settlement in circumstances where Taxation of Chargeable Gains Act 1992 section 87 gains would be visited on him. If he could instead gift his interest to the trustees of a United Kingdom resident settlement, the trust gains would not at that stage be visited on anyone. For while trust gains would be transferred to the transferee trust when the

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7 See generally my *Inheritance Tax Planning* 3rd edition Part C. For the Finance Act 2000 restriction, see my *Non-Resident Trusts* 8th edition 11.5A.5.5.

trustees became absolutely entitled to settled property comprised in the original settlement, that would not involve the transferee trustees realising gains. Instead the trust gains would continue to be available to be visited on beneficiaries of the transferee settlement who received capital payments from the trustees of that settlement.

4 When will Holdover Relief be Available?

4.1 The Possibilities

Where a disposal is made to an individual or trustees of a settlement[8] resident in the United Kingdom, a claim for holdover relief from capital gains tax can be made in certain circumstances. The result is that liability to the tax can be deferred until a later disposal. Such disposals can now attract holdover relief only if they fall within (a) section 165 or (b) Schedule 7 or (c) section 260 of the Taxation of Chargeable Gains Act 1992.

4.2 TCGA Section 165

4.2.1 The Statute

Taxation of Chargeable Gains Act 1992 section 165 applies to gifts by individuals of certain categories of assets, namely business assets and shares or securities in trading companies. The asset qualifies for relief if:

> "(a) it is, or is an interest in, an asset used for the purposes of a trade, profession or vocation carried on by –
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> (i) the transferor, or
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> (ii) his personal company, or
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> (iii) a member of a trading group of which the holding company is his personal company, or
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> (b) it consists of shares or securities of a trading company, or of the holding company of a trading group, where-

8 Or, in certain limited circumstances, to a company.

(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."[9]

4.2.2 Interest in a Business

If the trust is governed by English law or some law which is similar in this respect[10] then the beneficiary will, by virtue of his beneficial interest, normally have an interest in the underlying trust assets. If, say, the trustees permit settled property to be used by a tenant for life in possession for the purpose of a trade carried on by him, either alone or in partnership, then the beneficial interest in that settled property should qualify for relief. It is not, however, enough that the trustees use the underlying trust asset for the purposes of a trade carried on by them. The position is the same where trustees permit settled property to be used by the personal company of a beneficiary or by a member of a trading group of which the holding company is his personal company. It is not enough that the company is the trustees' personal company or that they hold 25% of the voting rights in it.[11]

4.2.3 Shares and Securities

The case where the settled property consists of shares or securities not listed on a recognised stock exchange is more difficult. Does a beneficial interest in such shares qualify? One's initial reaction is that it should. Otherwise, if, say, husband and wife jointly held shares as tenants in common and made a gift of them, they would not qualify for relief. There is a difficulty in that section 165(2)(a) specifically refers to an asset or interest in an asset, whereas section 165(2)(b) does not. Possibly, the reason is that the draftsman wished to make it clear that interests in trading partnership were within the section.

4.3 Taxation of Chargeable Gains Act 1992 Schedule 7

Taxation of Chargeable Gains Act 1992 Schedule 7 paragraph 1 applies to a disposal of an asset which is, "or is an interest in" "agricultural property" within the

9 Section 165(2).

10 See *Garland v Archer-Shee* (1930) 15 TC 693; [1931] AC 212.

11 Cf Taxation of Chargeable Gains Act 1992 Schedule 7 paragraph 2(b)(ii), which applies to holdover relief as respects a disposal made by the trustees themselves.

meaning of Chapter II of Part V of the Inheritance Tax Act 1984 (inheritance tax relief for agricultural property).[12] It can thus in principle apply to a beneficial interest in such property. It is a further condition that, apart from this paragraph, the disposal would not fall within section 165(1) by reason only that the agricultural property is not used for the purposes of a trade carried on as mentioned in section 165(2)(a). This is likely to be the case where the trustees or a tenant or company of theirs carries on a trade on the land.

Holdover relief under section 165 is to be available only:

> " if the circumstances are such that a reduction in respect of the asset-
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> (a) is made under Chapter II of Part V of the Inheritance Tax Act 1984 in relation to a chargeable transfer taking place on the occasion of the disposal, or
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> (b) would be so made if there were a chargeable transfer on that occasion, or
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> (c) would be so made but for section 124A of that Act[13] (assuming, where there is no chargeable transfer on that occasion, that there were)."

This is an extremely complex requirement. "Where the whole or part of the value transferred by a transfer of value is attributable to the agricultural value of agricultural property, the whole or that part of the value transferred shall be treated as reduced by the appropriate percentage ..."[14] If the beneficial interest is a proprietary interest in agricultural property, then relief is prima facie available. It might be asked whether relief is still available if the nature of the interest is simply a personal claim against the trustees. Its value is still "attributable to the agricultural value of agricultural property". Yet it is difficult to say that it is an interest "in" agricultural property, as required by Schedule 78 paragraph 1. Even if it is, if the beneficiary has not occupied the property for the purposes of agriculture throughout the period of two years ending with the date of the transfer, relief will be denied under section 117, discussed below.

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12 See RI 8 (November 1991).

13 Transfers within seven years before the death of the transferor.

14 Inheritance Tax Act section 116(1).

The general rule is that relief is not available in respect of any agricultural property unless-

"(a) it was occupied by the transferor for the purposes of agriculture throughout the period of two years ending with the date of the transfer, or

(b) it was owned by him throughout the period of seven years ending with that date and was throughout that period occupied (by him or another) for the purposes of agriculture."[15]

Whether condition (a) is satisfied is a question of fact. It is necessary, in order for condition (b) to be satisfied, for the agricultural property to be owned by the beneficiary. It is a moot point whether this requirement is satisfied if the beneficiary merely owns an interest in it. "Agricultural property" is defined[16] in terms of physical assets, not legal interests in those assets, which is helpful. It can hardly be supposed that the interests of a tenant in common of a freehold or of a lessee of agricultural land would not qualify. Why, not, therefore, the equitable interest of a beneficiary under a settlement?

Relief at the rate of 100% is normally available only if " the interest of the transferor in the property immediately before the transfer carries the right to vacant possession or the right to obtain it within the next twelve months".[17] Even if the interest of the trustees carries that right, the interest of the beneficiary may not.

The gift of some interests in settlements will not give rise to a transfer of value. The hypothesis that the donor makes a chargeable transfer is not always easy to apply.

4.4 TCGA Section 260

Section 260 applies where, under the inheritance tax legislation, the gift constitutes a chargeable transfer or a specified type of exempt transfer. It will be first necessary to enquire if the interest disposed of is a "reversionary interest". This is defined, by Inheritance Tax Act section 47, to mean: "a future interest under a settlement, whether it is vested or contingent (including an interest expectant on the

15 Inheritance Tax Act section 117.

16 By Inheritance Tax Act section 115(2).

17 Inheritance Tax Act section 116(2)(a).

termination of an interest in possession which, by virtue of section 50 below, is treated as subsisting in part of any property) and in relation to Scotland includes an interest in the fee of property subject to a proper liferent."

If the interest is a reversionary interest, it is next necessary to discover if it is "excluded property". If it is, then a disposal of it cannot amount to a chargeable transfer. Inheritance Tax Act section 48 provides:

> "(1) A reversionary interest is excluded property unless-
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> (a) it has at any time been acquired (whether by the person entitled to it or by a person previously entitled to it) for a consideration in money or money's worth, or
>
> (b) it is one to which either the settlor or his spouse is or has been beneficially entitled, or
>
> (c) it is the interest expectant on the determination of a lease treated as a settlement by virtue of section 43(3) of the Inheritance Tax Act."

If the interest is not a reversionary interest, then it is very likely to be an interest in possession. Now we are expressly told by Inheritance Tax Act section 51(1) that "where a person beneficially entitled to an interest in possession in settled property disposes of his interest the disposal ... is not a transfer of value". Prima facie that would appear to preclude holdover relief on the disposal of such an interest. Section 51(1) does go on to say, however, that it "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." Under section 52(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." This the disposal of an interest in possession can result in the owner of the interest being deemed to make a changeable transfer. Does that satisfy Taxation of Chargeable Gains Act 1992 section 260(2)(a), which provides:

> "A disposal is within this subsection if it is made otherwise than under a bargain at arm's length and –

(a) is a chargeable transfer within the meaning of the Inheritance Tax Act 1984 (or would be but for section 19 of that Act) and is not a potentially exempt transfer (within the meaning of that Act) ..."?

In my view, there is a strong argument that, on a purposive construction of section 260, it does. The inheritance tax legislation does not use the term "disposal": that is a term of art for the capital gains tax legislation. Hence for a disposal to "be" a chargeable transfer, it is, in my view, enough that the occasion of the disposal is also the occasion of a chargeable transfer made, or deemed to be made, by the person making the disposal the value transferred by which is calculated by reference to the value of the property disposed of.

If the interest is neither an interest in possession nor a reversionary interest, then whether or not a disposal of it constitutes a chargeable transfer will depend on the usual inheritance tax rules, just as if it were any other asset.[18]

The transfer of value must be a chargeable transfer i.e. not an exempt transfer or a potentially exempt transfer. The main case in which, in my view, a beneficiary disposing of his beneficial interest will be able to take advantage of section 260(2)(a) is where he disposes of his interest in possession so that it comes to be held on discretionary trusts.

18 See generally my *Inheritance Tax Planning* 3rd edition published by Key Haven Publications.