ADVANTAGES OF RESERVATION OF BENEFIT TRUSTS

Robert Venables QC[1]

1 Normally Undesirable

In general, it will be foolish to make a gift in settlement with a reservation of benefit which does not cease until one's death. The settled property will be brought into charge on one's death for inheritance tax purposes but there will be no corresponding uplift in the trustees' base cost for capital gains tax purposes. While any tax payable on the original gift in settlement will be allowed as a credit against the tax chargeable on death under Inheritance Tax (Double Charges Relief) Regulations 1987, there will have been a cash-flow disadvantage if tax was payable *inter vivos*. There may also be problems in obtaining exemptions and reliefs which would have been available if the property had remained in one's own estate.

2 The Strategy

It may be positively desirable, however, for a settlor to make a gift subject to a reservation of benefit if the alternative would have been his not making any gift at all, provided that there is a good possibility that the benefit will terminate more than three years before his death.

Suppose, for example, a settlor is setting up a new company the shares in which will initially have a very modest value. He hopes that the company will prosper and become extremely valuable. He does not feel that he can gift shares to his total exclusion. He is aged forty-five and expects that in ten years' time the business will have prospered so much that he will then be able to exclude himself entirely from any interest in the shares.

---

1 Robert Venables QC, Consulting Editor.

He should gift the shares into a trust at an early stage. Even if the trust is discretionary, the transfer of value will be minimal. Indeed, if he has made no chargeable transfers of value in the previous seven years, this will be an ideal opportunity to set up multiple discretionary trusts, each of which should in all probability never be exposed to a charge to inheritance tax during its life or on its termination.[2] The discretionary trusts could be of the old-fashioned variety under which the trustees have wide discretions as to both capital and income in favour of a specified class of beneficiaries including the settlor and any spouse of his.

The income tax settlement provisions (Taxes Act 1988 Part XV) would, of course, bite in principle. However, the position would be no worse than if the settlor had retained the shares himself. If no dividends are declared on the shares, the point is academic. The capital gains tax settlor rules[3] could similarly apply to tax gains of the trustees as if they were those of the settlor. Unless the shares are disposed of in a year in which the provisions apply, they too would present no problem.

Suppose, in ten years' time, the business has prospered so much and the settlor is so wealthy and secure that he feels he can cut himself out of any benefit under the settlement. If he does so, the reservation of benefit will then cease. Provided he survives for a further seven years there will be no charge to inheritance tax on his death by reference to the value of the settled property. If, by contrast, he had delayed making a gift for ten years, he could well then make a substantial chargeable transfer of value into the discretionary trust.[4] As the initial value of the settled property would be very substantial, the opportunities for creating multiple nil-rate discretionary trusts would be severely curtailed, if not removed. The capital gains tax position would not be improved. Even if it were possible to claim hold-over relief on the gift into the trust (which might not be the case after Finance Act 1989), it would be impossible on a sale of the shares to avoid paying tax on the rise in value from the date of their acquisition by the settlor to the date of the gift in settlement.

Where the settlor is considering making a gift in settlement which would qualify as a potentially exempt transfer, then the advantages of this strategy are not so obvious. The settlor could equally make the potentially exempt transfer in ten years' time and escape inheritance tax on his death by surviving a further seven years. The capital gains tax complications would still, of course, remain. The main imponderable is

---

2 See my *Inheritance Tax Planning* 3rd edition D.9.2.

3 See my *Inheritance Tax Planning* 3rd edition D.2.5.4.

4 Assuming that business property relief is reduced from its present level of 100%.

whether potentially exempt transfers will still exist in ten years' time. While there must be a real risk that a Labour government will eventually abolish potentially exempt transfers, at least on gifts in settlement, I consider it most unlikely that it would tax as though it were a chargeable transfer of value the termination more than seven years before the death of the donor of a reservation of benefit over a gift made under previous administration.

One must bear in mind the new rules relating to the rates at which capital gains tax is levied. If the trust were neither resident nor ordinarily resident in the United Kingdom, then, provided the Offshore Settlor Provisions did not apply, trustees would not suffer any direct charge to capital gains tax, although beneficiaries domiciled and resident or ordinarily resident in the United Kingdom who received capital payments from the trustees could find the trust gains visited upon them and taxed at their marginal rates.[5]

In the case of a UK resident trust, capital gains tax would be chargeable as though any gain realised by the trustees were a gain of the settlor for any year of assessment during any part of which he had "an interest" in the settled property.[6] There is no objection, however, to a settlor having an interest under a settlement in any part of the year in which the trustees do not realise any capital gain.

If the settlor provisions do not apply for a year of assessment, then, as a rule the trust will be liable to capital gains tax at both the basic and additional rates, instead of just the basic rate.[7]

3 Value-Shifting

Where the trustees of a settlement enter into a transaction whereby the value of the settled property is diminished, there are several anti-avoidance provisions which may levy a charge to tax on the settled property itself: see Inheritance Tax Act 1984 section 52(3), section 65(1)(b), section 70(2)(b), section 71(3)(b), section 72(2)(c), section 73(2)(b) and section 74(2)(b).[8] The gifts with reservation of benefit

5 See my *Inheritance Tax Planning* 3rd edition D.2.6 and my *Non-Resident Trusts* 7th edition Chapters 13 and 14.

6 See my *Inheritance Tax Planning* 3rd edition D.2.5.4.

7 See my *Inheritance Tax Planning* 3rd edition D.2.5.2.

8 See the House of Lords decision in *Macpherson v IRC* [1988] STC 362.

legislation, however, contains no corresponding general anti-avoidance provision aimed at value-reducing. It has been suggested to me by Mr Robert Argles of Counsel that where settled property is property subject to a reservation *quoad* the settlor, but the trustees of the settlement, acting *intra vires*, reduce the value of the settled property, then the value which falls to be brought into account by virtue of Finance Act 1986 section 102 on the death of the settlor is the reduced value of the property, notwithstanding that the reduction may have occurred shortly before his death. The same holds good in calculating the value transferred by the potentially exempt transfer which the settlor will be deemed by section 102(4) to have made should the reservation cease during his lifetime and following a value-reducing exercise.

Of course, the value-reducing exercise must be carried out in such a way as to ensure that none of the settled property ceases to be property subject to a reservation, as in that case section 102(4) would in terms apply. The technique must be to devalue property which nevertheless remains settled property. One should also keep closely in mind Finance Act 1986 Schedule 20 paragraph 5.

4 Reverter to Settlor Trusts

4.1 Inheritance Tax

Where settled property reverts to the settlor, whether absolutely or for an interest in possession, there could be a charge to inheritance tax. Where this charge would arise from the termination or disposal of an interest in possession or the death of a person entitled to an interest in possession, the charge is usually avoided by express exempting provisions.[9] This is no more than fair, as the settlor ought to be no worse off than if he had never created the settlement.

It has been suggested that it would be possible to overcome the gifts with reservation of benefit provisions by the donee settling the gifted property upon trust for the donor for life with remainder to the donee. It is said that Inheritance Tax Act 1984 section 54(1) would operate to prevent the settled property being taken into account for the purpose only of determining the value of the donor's estate immediately before his death; that it would not prevent the settled property forming part of his estate (on account of his being deemed to be beneficially entitled to it by Inheritance Tax Act 1984 section 49(1)) and thus Finance Act 1986 section 102(3) would not in terms apply.

---

[9] See my *Inheritance Tax Planning* 3rd edition D.11.4.5.

If this argument is correct, it must be emphasised that the strategy can be used only where the original gift has been made. Otherwise, the true "settlor" will be the donor. The gifts with reservation of benefit provisions will indeed not apply, but only because the settled property will be brought into charge on the death of the donor, there being no reverter to settlor.[10]

4.2 Capital Gains Tax

4.2.1 The Normal Rules

4.2.1.1 Deemed Disposals During Life of Settlements

On the death of the person entitled to an interest[11] in possession in all or any part of the settled property, the trustees of a settlement are deemed for capital gains tax purposes to dispose of and immediately reacquire for a consideration equal to its market value the whole or corresponding part of each of the assets forming part of the settled property, but no chargeable gain is to accrue on the disposal.[12]

For this purpose, an interest which is a right to part of the income of settled property is treated as an interest in a corresponding part of the settled property. If there is an interest in a part of the settled property and, where that is an interest in income, there is no right of recourse to, or to the income of, the remainder of the settled property, the part of the settled property in which the interest subsists is to treated for this purpose as being settled property under a separate settlement.[13] Where an interest in possession in part of settled property terminates and the part can properly be identified with one or more specific assets, or where within a reasonable time, normally three months, of the termination the trustees appropriate specific assets to give effect to the termination, the Revenue will accept that the deemed disposals and reacquisitions under TCGA 1992 ss.71, 72 (CGTA 1979 ss.54, 55) apply to those

---

10 The provisions were discussed in the context of a scheme, long since closed by legislation, by the House of Lords in *IRC v Countess Fitzwilliam* [1993] STC 502. See my *Inheritance Tax Planning* 3rd edition A.4.3.

11 See Finance Act section 72(3)(4). Prior to 6th April 1996, the provision in strict law applied only to a "life" interest in possession. By ESC D43, the Revenue would extend the treatment to all interests in possession. It was usually, but not always, advantageous to claim the concession.

12 Taxation of Chargeable Gains Act 1992 section 72(1).

13 Section 72(5).

specific assets, and not to any part of the other assets comprised in the settled property. The treatment must be consistent with that adopted for inheritance tax.[14]

There are comparable rules which apply on the death of a person entitled to any annuity payable out of, or charged on, settled property or the income of settled property.[15]

There is an exception where hold-over relief has been claimed on a gift in settlement.[16] The held-over gain is not "washed" but is clawed back on death. Prior to the 1989 Budget Speech, no immediate charge to capital gains tax need have arisen, even if the trust were UK resident. For an election for hold-over relief could have been made by the trustees. Whether an election can now be made will depend on the application of the new rules to the trust at the date of the death.

The effect of section 72 is thus normally beneficial. If the settled property has increased in value since the last acquisition (or deemed acquisition) by the trustees, there will be a tax-free uplift in the trustees' base cost. Section 72 will be disadvantageous insofar as the settled property comprises assets the sale of which would give rise to a loss. It would be advantageous for the trustees to realise any such assets, preferably by disposal to a non-connected person, before the death of the tenant for life.

4.2.1.2 Deemed Disposals on Termination of Settlement

The general scheme of Taxation of Chargeable Gains Act 1992 is that whenever property ceases to be settled property, the trustees will be deemed to dispose of it and reacquire it at its market value as bare trustees for the person becoming absolutely entitled to it: Taxation of Chargeable Gains Act 1992 section 71(1).

A charge to capital gains tax on the trustees will in general be avoided, by section 73, provided that, if the property ceased to be settled property, there would have

---

14 See Inland Revenue SP D10.

15 Section 72(3) and (4).

16 Or on a prior deemed disposal by the trustees under section 72. See Taxation of Chargeable Gains Act 1992 section 74.

been a section 72 disposal.[17] The section 72 rules concerning interests in part only of the settled property and annuities are expressly imported into section 73. Similarly, SP D10 applies for the purposes of sections 71 and 73.

There is the same limitation to the exemption from a charge to capital gains tax where hold-over relief has previously been claimed on the acquisition of assets by the trustees.

4.2.2 Reverter to Settlor

Where on the death the property reverts to the "disponer", i.e. settlor, the disposal and reacquisition are be deemed to be for such consideration as to secure that neither a gain nor a loss accrues to the trustee.[18] Can one have the best of both worlds so as to prevent a charge to inheritance tax when the property reverts to the settlor on the death of, say, a life tenant, yet give the settlor the advantage of a tax-free uplift for capital gains tax purposes? In my view, one can.

The inheritance tax exemption is contained in Inheritance Tax Act 1984 section 54(1), which provides:

> "(1) Where a person is entitled to an interest in possession in settled property which on his death, but during the settlor's life, reverts to the settlor, the value of the settled property shall be left out of account in determining for the purposes of this Act the value of the deceased's estate immediately before his death."

In my view, there will be a reverter to the settlor if the settlor becomes entitled for an interest in possession on the death. That is because a person entitled for an interest in possession is deemed to own the settled property: Inheritance Tax Act 1984 section 49(1). For capital gains tax purposes, however, the settlement continues. If, say, a year later the settlor becomes absolutely entitled, Taxation of Chargeable Gains Act section 73(1)(b) will not apply at that point. Hence, he obtains the best of both worlds.

It may sometimes be helpful to avoid section 73(1)(b) applying even where an interest in possession terminates *inter vivos*, as where the trust asset is a residence

---

17 See 11.5.2 *Non Residents Trusts,* 7th Edition. Before 6th April 1996, this section too applied only to the termination of a "life" interest in possession. There is the same exception where hold-over relief has been previously claimed. ESC D43 likewise applied to determine what the Revenue would treat as a "life interest" for the purposes of section 73(1).

18 See Taxation of Chargeable Gains Act 1992 section 73(1)(b).

which has been the principal residence of the beneficiary. In such a case, a comparable strategy may be adopted. The relevant provision of the Inheritance Tax Act 1984 is section 53(3), which provides:

> "Tax shall not be chargeable under section 52 above[19] if the interest comes to an end during the settlor's life and on the same occasion the property in which the interest subsisted reverts to the settlor."

This does not differ in principle from section 54(1).

---

19 The normal charging provision on the termination of an interest in possession *inter vivos*.