GIFTS WITH RESERVATION WRINKLES

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The basic principles of gifts with reservation ("GWR") are as set out in FA 1986 s.102 Sch 20. This is a virtual recodification of the Estate Duty rules whereby, to be effective, a donor cannot directly or indirectly, or by associated operations, benefit from strings attached, subject to certain exceptions.

In this article some 9 wrinkles, significant aspects, on this grey area topic are discussed.

- The rules do not apply to pre 18th March 1986 transfers, for example into a discretionary settlement, even if the reservation of benefit arises after that date, s.102(1). If assets are added to such settlements then the GWR provisions apply to such additions on a pro rata basis.

- GWR's have undoubted capital gains tax ("CGT") disadvantages. As they are lifetime gifts, the CGT death exemption and market value uplift cannot apply: TCGA 1992 s.62; so that where GWR applies, there is no inheritance tax ("IHT") advantage (as the assets remain in the estate owner's estate) but there may well be a CGT disadvantage as a lifetime disposal has occurred. In some fairly rare circumstances, the incurring of the CGT charge on the GWR gift could have advantages, namely where a PET non-GWR is intended in the future and a GWR gift is made now to crystallise the CGT liability on a sooner rather than later basis. For example, the earlier GWR disposal occurs when the gain element is lower, e.g. non vacant possession value;, where a rise in value is anticipated; there are political fears of anti-avoidance provision; obtaining the higher retirement relief; making a gift where the CGT private residence exemption applies in full now but only pro rata in the future (see *Trusts & Estates* August/September 1998 page 57 and Robert Venables QC *The Personal Tax Planning Review* Vol 7, Issue 1 1999 page19).

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- A benefit in part of the asset is likely to taint the whole subject to exclusions for "virtually". For examples see *Revenue Manual* Volume I Chapter D d44 and *Revenue Tax Bulletin* No 9 November 1993 page 98. In contrast, for sales at under value GWR element is only applied as to the gift element, see Manual Volume I Chapter D d30.

- As regards chattels it should be possible to avoid a GWR if the donor pays an arm's length premium or rent for keeping the chattels for life. Note that the new anti-Ingram anti-avoidance provisions in Finance Act 1999 s.104 introducing new FA 1986 s.102A applies to land but not chattels.

- GWR and the inter-spouse exemption - use of life interest. The strategy is for say husband ("H") to make a gift to a trust under which wife ("W") takes an initial interest in possession for life or for 6 months, whichever is the shorter. H and W are capable of benefitting in the reversionary interest, e.g. by being added as possible beneficiaries.

A gift to a settlement under which the settlor's spouse enjoys an interest in possession will normally constitute a transfer of value as the settlor's estate will be diminished in value by the gift. The precise extent of the diminution will depend upon what interest the settlor retains in the settled property.

Provided the settlor's spouse is domiciled in the United Kingdom, however, the transfer of value will normally be entirely exempt. The settlor's spouse will be deemed to own the settled property by virtue of IHTA 1984 section 49(1) and thus the entire transfer of value will be attributable to property which becomes comprised in the estate of the transferor's spouse, section 18(1).

Although the settlor will almost certainly have made a gift, Finance Act 1986 s.102 will not apply as it is in terms excluded by s.102(5)(a). Hence, the settlor (or spouse) may reserve whatever benefits he wishes over the settled property. The position is the same as if Finance Act 1986 had not been enacted.

If the reversionary interest is of a discretionary nature, keep the fund within the nil rate band (or business/agricultural property eligible for the 100% discount); because the termination of the spouse's short term life interest is deemed a chargeable transfer by her (not a PET). If the proposed fund exceeds the nil rate band (or is not such BPR/APR), the reversionary interest could be a flexible, revocable interest in possession to which settlor and spouse can be added as beneficiaries.

The section 102(5)(a) exemption will come into play only if the gift in settlement constitutes a transfer of value and one which is exempt by virtue only of the spouse exemption.

A gift of excluded property, for example, would not constitute a transfer of value at all. One must also ensure that the maintenance exemption contained in section 11 does not apply.

Robert Venables QC does not agree with the argument (suggested by McCutcheon on IHT 1988 edition at 6-17) that the settlor has made two separate gifts; one to spouse which is exempt, the other of the reversion to the discretionary or interest in possession trust which is not exempt. The settlor has disposed of one piece of property (which has become the underlying trust property), so as to create several different items of property namely the equitable interests of the beneficiaries.

- Avoidance of double charge: FA 1986 s.104.

The structure of IHT means that in certain circumstances the same property can be charged twice and entered twice into the cumulation of chargeable transfers as a result of a transferor's death. The Board have made regulations (SI 1987/1130) which provide for relief in these circumstances.

Regulation 5 provides for the avoidance of double charge where there is a transfer of value by way of gift of property which is or subsequently becomes a chargeable transfer, and the property is (by virtue of the provisions relating to gifts with reservation) subject to a further transfer which is chargeable as a result of the transferor's death. Under regulation 4, whichever transfer produces the higher amount of tax as a result of the death remains chargeable and the value of the other transfer is reduced by reference to the value of the transfer which produced the amount. However, this reduction in value does not apply for the purposes of any discretionary trust charges arising before the transferor's death if the transfer by way of gift was chargeable to tax when it was made. Further, provision is made for credit to be given on account of any tax already paid on the transfer by way of gift against so much of the tax payable on the other transfer as relates to the value of the property in question.

Example:

A gives B a house, but reserves the right to continue to live in it, and does so until he dies five years later. There is a charge on the gift from A to B because it is within seven years of death, but because this is a gift with reservation the house is also charged as part of A's death estate.

- GWR and variations under IHTA 1984 s.142.

Where a testator has died and a beneficiary of the estate effects a variation, e.g. by varying an outright gift to that beneficiary into a discretionary trust, the fact that the beneficiary is capable of benefiting from the varied gift, e.g. by being included as a discretionary object, does not constitute a reservation of benefit by that beneficiary because for IHT it is the deceased who is deemed to have created the varied gift, e.g. the discretionary trust.

- *Ingram v CIR* [1998] STC 37. The House of Lords unanimously decided that lease carve outs do not constitute gifts with reservation on the basis that when an estate owner retains is no gift. Finance Act 1999 s.104 incorporates new FA 1986 ss.102A, B and C with a view to preventing most Ingram lease carve out for arrangements on or after 9th March 1999 where the donor or his/her spouse has a significant right or interest, or is a party to a significant arrangement relating to the land.

However, these extended provisions should not apply where the gift is made more than seven years after the right, interest or arrangement concerned is created or entered into.

This latter exclusion indicates that the GWR problems can be avoided if the estate owner uses a 14 year window.

Example:

Lady Isabel carves out a lease for herself and her husband for 20 years on 10th March 1999. On the 11th March 2006 she gives away the freehold reversion to her children - i.e. as a PET. Lady Isabel dies on 12th March 2013. The gift of the freehold reversion appears to be effective as a PET and without GWR problems.

HM Treasury Explanatory Notes to Finance Bill 1999 state: "For example a lease created and retained by a donor will not be a reservation in relation to the gift of the freehold reversion made more than seven years after the creation of the lease".

Contrast the normal GWR rules where time does not run at all towards the PET requirement in favour of the estate owner whilst he/she retains the benefit.

- The reversionary/deferred lease schemes appear to have survived the Finance Act onslaught. Under this popular arrangement the estate owner could retain the freehold and grant a long term, e.g. 999 year lease, at a nil rent to arise after a specified number of years in the future. That number of years would be gauged to give the individual and spouse the required length of occupation as freeholder.

It appears that these reversionary/deferred lease arrangements may well have survived the Finance Act onslaught, if the donor/estate owner of the freehold has owned it for at least 7 years prior to the grant of the deferred lease. Under the provisions of new section 102A subsection 5 "a right or interest [i.e. (or because that freehold was itself acquired for full consideration) the freehold right of occupation] is not a significant arrangement for the purposes of sub-section 2 [the new anti-avoidance charge] if it was granted or acquired [i.e. the freehold] before the period of seven years ending with the date of the gift [the gift being the reversionary/deferred lease which constitutes a PET]".

IHT like the old estate duty is a voluntary tax. The problem for the estate owner and the countervailing consolation for the Revenue is that to be such a "volunteer" is not a bed of roses.