The Personal Tax Planning Review

HOLD-OVER RELIEF VIA REVOCABLE SETTLEMENTS

Robert Venables QC[1]

1 The Problem

Hold-over relief from capital gains tax may be available on a gift to a UK resident individual or settlement so that, on a claim being made, liability to the tax can be deferred until a disposal for valuable consideration.[2] Such disposals can now attract hold-over relief on gifts only if they fall within (a) Taxation of Chargeable Gains Act 1992 section 165 or Schedule 7, or (b) Taxation of Chargeable Gains Act 1992 section 260.

Section 165 applies to gifts of certain categories of assets, namely business assets and shares or securities in trading companies. Schedule 7 applies to agricultural property. Section 260 applies where, under the inheritance tax legislation, the gift constitutes a chargeable transfer or a specified type of exempt transfer or a beneficiary becomes absolutely entitled to property comprised in an accumulation and maintenance settlement.

2 The Strategy

Various strategies have been developed whereby a gift is made to a discretionary (technically a "relevant property") trust, the gift constituting a chargeable transfer of value, so that hold-over relief is available, but the value transferred being so small that very little, if any, inheritance tax is payable. Some of these strategies rely on the settlor making a gift into a settlement which is revocable by him, at

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2 Finance Act 1980 section 79, which, as amended, conferred widespread hold-over relief, was repealed in its entirety in relation to disposals on or after 14th March 1989 by Finance Act 1989 section 124.

least for a while. The basic idea is that, as the settlement is revocable, there will be retained in the settlor's estate immediately after making the gift a valuable asset, namely the right of revocation, which will diminish the value transferred on the making of the gift in settlement. When this power of revocation disappears, matters will be so arranged that it will give rise to only a potentially exempt transfer of value.

My own view is that such a strategy works in principle, although enormous attention needs to be paid to the fine tuning. I have been advising clients on my particular variant for several years and have not heard of any of them experiencing any challenge from the Revenue. To my mind, this is a highly moral form of tax planning as all it does is enable one to circumvent the arbitrary and unjust restrictions on hold-over relief which the Revenue panicked Parliament into enacting in 1989.[3] In this article I shall point out some traps and discuss some possible objections. Needless to say, it can be no substitute for professional advice from a trusts and tax practitioner on a case by case basis.

3 The Gift Must Remain Settled

There must be an initial period during which there is no interest in possession in the settled property; otherwise, the gift will be a potentially exempt transfer. It is an essential feature of the strategy that the trusts which supervene at the end of the initial period must be interest in possession or accumulation and maintenance trusts. The strategy is dependent on the gifted property continuing to remain settled. If it is desired that the beneficiary become absolutely entitled to the settled property, then, unless the trusts are accumulation and maintenance trusts, it will probably not be possible under current law to avoid a charge to capital gains tax. It is always possible, of course, that it may be possible in future to vest assets in a beneficiary absolutely without a charge to tax, as it was until the 1989 Budget Speech.

4 What is the Value Transferred by the Chargeable Transfer?

4.1 The General Principle

Although the original gift to the settlement will constitute a chargeable transfer of value, one will ensure that the "value transferred" (on which the inheritance tax payable depends) will be extremely low and will be nothing like the value of the

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3 For my criticism of the 1989 changes, see my *Inheritance Tax Planning 3rd edition* C.2, especially C.2.3, set out in the Appendix to this Article.

property gifted. The value transferred is measured by the diminution in the estate of the transferor, the settlor, as a result of transferring assets to the settlement: Inheritance Tax Act 1984 section 3(1). Immediately before the transfer, there is deemed to be comprised in his estate for inheritance tax purposes the assets to be gifted at their market value without allowing any deduction for capital gains tax which would be payable if he were to sell them.

4.2 The *Prima Facie* Position

The calculation of the value of the settlor's estate after the assets have been gifted is much more complex. If he has power to revoke the settlement at any time during an initial period, then *prima facie* he can revest the assets transferred in himself at any time during this period and thus there would appear to be no diminution in the value of his estate as a result of making the settlement. For before making the settlement he has the assets themselves, whereas after making the settlement he has the right to revest the assets in himself, which is for all practical purposes apparently worth as much as the assets themselves. Thus, there would not at first blush appear to be any diminution in his estate.

4.3 Inheritance Tax Charge on Revocation

The *prima facie* position is not, however, entirely accurate, because of the incidence of taxation. If the settlement were to be revoked before one complete quarter had elapsed, then there would be no charge to inheritance tax: Inheritance Tax Act section 65(4). For during that period the settled property would constitute "relevant property" for inheritance tax purposes: see Inheritance Tax Act 1984 section 58(1). Section 65 of that Act imposes a charge to inheritance tax when relevant property ceases to be such, as it would if it were revested in the settlor absolutely on exercise of the power of revocation. There is no charge, however, if the event occurs before the settlement has been in existence for one complete quarter: Inheritance Tax Act section 65(4).

4.4 Capital Gains Tax Charge on Revocation?

The principal difficulty, however, is one of capital gains tax. If the settlement were revoked and no inheritance tax were payable on that occasion, then in all probability capital gains tax would be payable and no election for hold-over relief would be available. When a settlement comes to an end, the trustees are deemed, by Taxation of Chargeable Gains Act 1992 section 71, to dispose of the settled property for a consideration equal to its market value. On the basis that hold-over relief from capital gains tax had been obtained when the property was put into settlement, that would involve the trustees realising a very considerable gain, which would be taxed under current law as the settlor's, very probably at a rate of 40% (after taking into account a very modest annual exemption and any part of the income tax lower and basic rate bands which had not otherwise been utilised).

Thus, if the settlor were to put property into a trust which he could revoke only before the first quarter had elapsed, he would arguably thereby have made a considerable chargeable transfer of value. Before making the settlement, the assets would have been comprised in his estate at their full value. After making the settlement, he could only revest the assets in his estate subject to the capital gains tax which would have become payable by the trustees and which would, by virtue of the trustees' lien, be charged in equity on the settled property. Thus, for the purposes of illustration, if the settlor were to transfer shares worth £1,500,000 to the trustees and the capital gains tax which would be payable by the trustees on a deemed disposal of the shares at market value would be £421,000, then, he would *prima facie* be deemed to make a chargeable transfer of at least that amount. Assuming that his nil-rate band and annual exemptions for the current and previous years had not otherwise been utilised, that would leave at least £200,000 of chargeable transfer taxable at the rate of 20%. That is, there would be an immediate tax bill of £40,000. Moreover, if he did not survive the seven year period, the tax would be increased. For example, if he died within a three year period the tax payable would be doubled to £80,000.

4.5 The Solution

It is therefore crucial that the settlor should be able to revoke after the expiration of the first complete quarter, but while the trusts are still "relevant property" trusts. If he then did so, there would be an occasion of charge to inheritance tax under section 65 of the Inheritance Tax Act, albeit the charge would be very modest. Because of the existence of that charge, he and the trustees would be able to make a further election for hold-over relief so as to prevent any capital gains tax being payable on termination of the settlement. Hence, he could revest the settled property in himself free of any charge to capital gains tax and subject only to a modest inheritance tax charge, under section 65 of the Inheritance Tax Act.

It should be noted that when assets are transferred to a settlement by way of gift, an election for hold-over relief can (if available) by made by the settlor alone. When settled property ceases to be subject to the trusts of a settlement, however, any election for relief must be made jointly by the trustees of the settlement and the person who becomes "absolutely entitled" as against them. It might be objected that the settlor could not insist on the trustees joining in making the election. While my own opinion is that as a matter of Equity the trustees would be obliged to act in the best interests of the recipient beneficiary and that they would therefore be obliged to join in making the election (provided they were sufficiently protected against any personal liability, which could easily be achieved by, for example, their continuing to retain legal title to the assets in right of their lien as trustees), there is no authority directly in point and the taxing statutes are silent on the matter. To avoid any argument, therefore, one should incorporate in the settlement an appropriate provision.

4.6 Rate of Inheritance Tax Charge on Revocation after First Quarter

One needs to consider the rate at which inheritance tax would be chargeable under section 65 if the settlement were revoked during the period of "relevant property" trusts but after the expiration of one quarter. If only one complete quarter had elapsed, tax would, by virtue of section 68(2) of the Inheritance Tax Act 1984, be chargeable at one-fortieth of three-tenths of the "effective rate". The effective rate cannot exceed the maximum rate of inheritance tax for lifetime gifts, currently 20%. Thus, the maximum rate of the charge on the revocation of the settlement in this period would be one-fortieth of three-tenths of 20% = 0·15% of the value of the trust fund.

4.7. Calculation of Value Transferred by Initial Chargeable Transfer

One is now at last in a position to calculate the value transferred by the settlor on the gift in settlement. In valuing a person's estate for inheritance tax purposes, one assumes that they would market the assets comprised in the estate in the best possible way. Thus, once the settlor had made the settlement, his best way of turning his power of revocation to pecuniary account would be to exercise it so that the settled property was revested in him with a minimum charge to tax. This would be done by revoking the settlement after the first quarter and while the settled property was still "relevant property". Given that the settled property will revert to the settlor's estate, the only diminution in value of his estate would appear to be the inheritance tax charge of a maximum of 0·15% of the value of the settled property plus the value of the income arising before revocation. If the figures are such that the exit charge may be at a nil rate, one can confer on the trustees a power of diversion of a modest amount of capital to be absolutely sure that there is in fact some value transferred by the initial chargeable transfer and that it cannot be ignored on the *de minimis* principle.

It is just possible that the transfer of value which the settlor would make as a result of settling the assets would be so small that it would in all probability be covered by his unused annual exemption of the current and previous years, which might total £6,000. Hence, it would be an exempt transfer of value rather than a chargeable transfer. It might be asked whether this would prejudice the entitlement of the settlor to make an election for hold-over relief pursuant to Taxation of Chargeable Gains Act 1992 section 260. It would not, as that provision in terms applies not only to a chargeable transfer proper but to a transfer which would be a chargeable transfer but for section 19 of the Inheritance Tax Act, which contains the annual exemption: see section 260(2)(a).

4.8 Premature Death of Settlor

There is, however, another factor, namely the possibility of the settlor's death before the first quarter has elapsed. This objection too needs to be overcome by incorporating an appropriate provision in the settlement.

4.9 Gifts with Reservation of Benefit Provisions

It might be asked whether the gifts with reservation of benefit provisions prevent the settlor from making any transfer of value. The Revenue would almost certainly argue if necessary that where the settlor retains a power to revoke a settlement, the settled property is property subject to a reservation within the meaning of Finance Act 1986 section 102. Even if that is correct, the property is not thereby deemed to form part of the settlor's estate immediately after the gift. Instead, certain consequences follow when the property ceases to be subject to a reservation. Even if the reservation continues until the settlor's death, the property is deemed to be comprised in his estate only immediately before the death: see section 102(3).

4.10 Is there really an Exit Charge on Revocation after the First Quarter?

4.10.1 The Supposed Problem

I now consider three objections, each based on the argument that if the power of revocation were to be exercised, there would not be a chargeable transfer and hence the trustees and the settlor could not elect for hold-over relief. This would mean that the settlor had made a more substantial chargeable transfer at Day One.

4.10.2 Is the Settled Property of No Value?

The first argument is that "because the settled property is subject to a power of revocation it has no value", the amount transferred by the chargeable transfer would be nil and hence there would in effect be no chargeable transfer. This is in my view unsound. The settled property is the property the legal title to which is held by the trustees. One ignores equitable rights, powers and interests in that property in ascertaining what it is and what its value is. The power of revocation is such an equitable interest. The position would be different if the power to deprive the trustees of the asset were inherent in the asset itself rather than one which arose under the trusts which have been declared of it. For example, where a lease is granted to trustees determinable by the lessor on short notice, it is quite proper to take into account the power of determination in valuing the lease and hence the settled property. By contrast, the fact that the trustees are bound to part with the settled property if a power of revocation is exercised is no more relevant than if they are bound to part with the property because a beneficiary becomes absolutely entitled to it under fixed trusts.

4.10.3 *Dymond*

The second argument is based in a passage in *Dymond's Capital Taxes*, at 5.502. *Dymond* says that when a settlement is revoked the transfer back to the settlor is not a transfer of value because the trustees "would be obliged to disgorge [the settled property] and would not be making a disposition with a gratuitous intent". The statement that there is no transfer of value is technically right but for the wrong reasons and is an irrelevance. The reason the trustees have made no transfer of value is because they have made no disposition: see the definition in section 3(1). Whether they have made a transfer of value is in any case irrelevant because, not being made by an individual, it could never be on that account a chargeable transfer: see the definition in section 2(1).

The only question is whether they have made a chargeable transfer on the revocation because that is an occasion on which tax is chargeable under Part III Chapter III of the Act: see section 2(3). In my view, it clearly is. My guess is that the reasoning of the learned authors of *Dymond* was as follows:

> "Tax may be charged under section 65(1)(b) "where the trustees of the settlement make a disposition as a result of which the value of relevant property comprised in the settlement is less than it would be but for the disposition"; section 65(6) provides that tax is not to be charged under section 65(1)(b) if the disposition is such that, were the trustees beneficially entitled to the settled property, section 10 or section 16 would prevent the disposition from being a transfer of value; section 10 applies to dispositions not intended to confer a gratuitous benefit on any person; the trustees have no such gratuitous intent, hence there is no charge under section 65(1)(b)."

What they have overlooked is that section 65(6) is relevant only in avoiding a chargeable transfer under section 65(1)(b). Yet the charge in this case would be under section 65(1)(a) and not (b), because the property ceases to be relevant property. Section 65(1)(b) applies only in a case where (a) does not apply.

4.10.4 *CHH British Tax Reporter*

A third argument is based on a passage in *CHH Edition's British Tax Reporter* at 419-140 where the impression is given that where a non-interest in possession settlement is revoked the trustees could argue that there is no exit charge. This is in my view erroneous. It again overlooks that the charge is under section 65(1)(a) and not (b) and that subsection (6) provides an exemption only from (b).

5 Lapse or Release of Power?

5.1 Dangers of Release

Should the power of revocation be limited in time and, if so, should the settlor release it or should it merely be allowed to lapse? If he releases it, then he will have undoubtedly made a transfer of value. If the trusts are then relevant property trusts, that transfer will be a chargeable one. Even if the trusts are interest in possession or accumulation and maintenance trusts, there is a real risk that it will not qualify as a potentially exempt transfer. The conditions contained in section 3A(1)(c) of the Inheritance Tax Act would arguably not be satisfied, at least in full. The gift must constitute "a gift to another individual or a gift into an accumulation and maintenance trust ...".

A transfer is exempt as a "gift to another individual" to the extent either that the value transferred is "attributable to property which, by virtue of the transfer, becomes comprised in the estate of that other individual" (section 3A(2)(a)) or that "by virtue of the transfer, the estate of that other individual is increased" (section 3A(2)(b)). Now, no property becomes comprised in the estate of any individual by virtue of the release. Is it possible that the estate of another individual may be increased? If the trusts are interest in possession trusts, in reality the estate of the beneficiary entitled in possession will have been increased. Yet for inheritance tax purposes, he was already deemed to own the settled property: Inheritance Tax Act section 49(1). Given that the settlor's right of revocation was one arising under the settlement (just like an overriding power of appointment reposed in trustees) rather than a right adverse to the settled property itself (such as the landlord's right to terminate a lease prematurely),[4] the settled property itself will not have increased in value. It is always possible that the estate of some beneficiary not entitled in possession will have increased in value, but that would normally involve only a small part of the value transferred being potentially exempt.

[4] See 4.10.2.

Similarly, the release will not be a gift into an accumulation and maintenance trust in that no property will, as the result of the release, become held on accumulation and maintenance trusts. It is again quite possible that the estate of some beneficiary not entitled in possession will have increased in value, so that the gift might be potentially exempt in part as a gift to an individual, but that would normally involve only a small part of the value transferred being potentially exempt.

5.2 Lapse of Power

5.2.1 A Possible Problem

What if the power is limited in time and simply allowed to lapse? Will the settlor then make a transfer of value by omission? In my view, ignoring associated operations and *Ramsay*, that will depend on the trusts of the settlement. Inheritance Tax Act section 3(3) provides:

> "Where the value of a person's estate is diminished and that of another person's estate, or of settled property in which no interest in possession subsists, is increased by the first-mentioned person's omission to exercise a right, he shall be treated for the purposes of this section as having made a disposition at the time (or latest time) when he could have exercised the right, unless it is shown that the omission was not deliberate."

For the reasons given above, the estate of the beneficiary entitled for an interest in possession will not be increased nor, if there is no such beneficiary, will the settled property be increased in value. Depending on the trusts, the estate of a beneficiary not entitled in possession could be increased. If it is, then the valued transferred by the disposition (and hence the transfer of value) deemed to be made by the settlor will be measured by reference to the entire diminution in his estate, not just the extent to which the estate of the other person was increased. Just as in the case of a release, it is unlikely that much of that value will be treated as transferred by a potentially exempt transfer, with the result that the settlor will make a substantial chargeable transfer.

5.2.2 One Solution

If there is a problem, one solution is so to draft the trusts as to ensure that there is no diminution in value of the settlor's estate as a result of the deemed transfer of value.

5.2.3 When Should the Power Lapse?

Care must be taken as to the time at which the power of revocation will lapse if not exercised. If the power were to lapse while the trusts were "relevant property" trusts, it might be argued by the Revenue that the settlor had made a disposition by associated operations, the second operation consisting of the omission to exercise (at the last moment at which it was exercisable) the right of revocation or of the release of the power. If that were right, he would have then made a very substantial chargeable transfer.

If the power were to lapse while the trusts were interest in possession or accumulation and maintenance trusts, the Revenue might similarly argue that the settlor had made a disposition by associated operations which was a potentially exempt transfer. Now, the settlor must sooner or later make a potentially exempt transfer, preferably as soon as consistent with the obtaining of hold-over relief and the avoiding of any substantial chargeable transfer of value. Hence, a potentially exempt transfer by associated operations would be a problem only if it followed that the settlor had not made a chargeable transfer on the day he made the settlement. In my view, that would not be the case. Inheritance Tax Act section 268(3) expressly recognises that a later transfer of value by associated operations does not cause an earlier transfer of value consisting of one or more of those operations to be deemed not to have been made. For, subject to an immaterial exception, it requires the value transferred by all the associated operations to be reduced by the value transferred by the earlier operations. My own preferred strategy in fact ensures that there is no problem, even if I am wrong in my view of the law.

One must also consider the inheritance tax gifts with reservation of benefit provisions, contained in Finance Act 1986. The Revenue would undoubtedly argue, with much force in the context, that the settling of the shares by the settlor constituted a disposal of them by way of gift with a reservation of benefit so long as the power of revocation subsisted. That benefit would, however, come to an end when the power lapsed. Assuming the settlor to be then still alive, he would be deemed by virtue of section 102(4) of the Finance Act 1986 to make a potentially exempt transfer. The concern would be that the settlor might make two potentially exempt transfers of value in respect of, in effect, the same underlying property and that the Inheritance Tax (Double Charges Relief) Regulations 1987 would not provide full relief from a potential double charge. Advisers will form their own view as to the extent to which there is a problem and, if so, how it should be resolved. My own solution is to ensure that any potentially exempt transfer deemed to be made under the gifts with reservation of benefit provisions is identical to that which the settlor would make apart from the provisions.

6 The Inheritance Tax Act Section 5(2) Argument

One must also consider an argument against the effectiveness of the strategy based on Inheritance Tax Act section 5(2), which provides:

> "A person who has a general power which enables him, or would if he were sui juris enable him, to dispose of any property other than settled property, or to charge money on any property other than settled property, shall be treated as beneficially entitled to the property or money; and for this purpose "general power" means a power or authority enabling the person by whom it is exercisable to appoint or dispose of property as he thinks fit."

The argument is that a power to revoke a settlement is a general power of appointment. If it were exercisable over property which is not settled property, the donee of the power would be deemed to own the property; from that it is said to follow that the donee of a general power of appointment over settled property is deemed not to own the settled property; nor is his right to be treated as having any value. Thus the settlor makes a chargeable transfer equal to the value of the property he is gifting to the settlement.

In my view, this argument is totally illogical. It is of the form

> "1 If A, then B
> 2 Not A
> 3 Therefore not B"

An example would be: "If he is English, he is British. He is not English. Therefore he is not British." Even if the argument were otherwise valid, it would merely lead to the conclusion that a person who has a general power of appointment over settled property is deemed not to own the settled property itself. That does not mean for one moment that the value of any right or interest he has over the settled property is to be disregarded. For example, if I settle property upon trust for A for life with remainder to myself, I neither own the settled property nor am deemed to own it, but that does not prevent the value of my remainder interest in the settled property being taken into account in valuing my estate.

The subsection has no application whatsoever to settled property. The only difficulty in interpreting the subsection is in determining when it can apply at all, for under the law of England is it difficult to imagine a situation where, since 1926, a general power of appointment can exist over property which is not "settled property" within the meaning of section 43 of the Inheritance Tax Act. The short answer is that section 5(2) probably has no application at all in England[5] and the draughtsman of the Finance Act 1975, the predecessor of the Inheritance Tax Act, adapted it from the very different context of estate duty[6] which was enacted before the 1925 property legislation prevented powers of appointment from subsisting at law and required them to take effect only in equity, i.e. under a settlement, but failed to see that in the world of capital transfer tax and the post-1925 property legislation it was neither needed nor effective.

7 *Furniss v Dawson*

One must also consider whether the Revenue could argue that the doctrine in *Furniss v Dawson* applies so that one should disregard the initial trusts as steps inserted for tax avoidance purposes and treat the settlor as having made a gift by a potentially exempt transfer to an interest in possession trust or accumulation and maintenance trust after the expiry of the initial trusts. In my view, it does not. The settlor might die during the period of "relevant property" trusts, in which case he could not be treated as having made a transfer of value when such trusts came to an end. Thus, there is not the requisite degree of predestination, as required by *Craven v White*.[7]

In any case, it is clear from the decision of the House of Lords in *Countess Fitzwilliam v Commissioners of Inland Revenue*[8] that it is not enough that the steps in a tax planning scheme are pre-ordained. One must also go on to ask "whether realistically they constituted a single and indivisible whole in which one or more of them was simply an element without independent effect and whether it is intellectually possible so to treat them." In that case a mother gifted a cash sum to the daughter which the daughter was to use to purchase from the mother at a gross overvalue a short-term interest in possession under a trust which had been created by the trustees for the purposes of the scheme. The House of Lords refused to treat this as a gift of the interest in possession from the mother to the daughter, which they could so easily have done. They relied on the fact that each step in the scheme gave rise to tax consequences of its own and that if the mother had died before the sale of her interest, capital transfer tax would have been payable. So too, in this case, the gift at Day One gives rise to a chargeable

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5 It might conceivably have an application in Northern Ireland.

6 In particular Finance Act 1894 section 22(2)(a).

7 [1988] STC 476.

8 [1993] STC 502.

APPENDIX

Extract from Venables on *Inheritance Tax Planning* 3rd Edition.

PART C - CAPITAL GAINS TAX ON LIFETIME GIFTS

CHAPTER C.2 HISTORY AND CRITIQUE

C.2.1 The Deemed Market Value Consideration Rule

C.2.1.1 The Rule

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 deemed to dispose of the asset for a consideration equal to its market value: Taxation of Chargeable Gains Act 1992 section 17. Although the donee can be assessed and charged to the tax if the donor does not pay, it is the donor who is primarily liable: Taxation of Chargeable Gains Act 1992 section 282(2). As a corollary, when the donee comes to dispose of the asset he is treated as having given the same consideration for it which the donor is deemed to have received, so that he is in fact taxable on a gain which is less than his true gain.

Overall, the combined gain of the donor and the donee is equal to the gain the donor would have realised had he not gifted the asset but disposed of it at the time of the donee's disposal. Where there is a chain of gifts, the same result is obtained by treating all the donors and donees as one person. Not surprisingly, the actual legislation contains many quirks and oddities so that this principle is not always given effect to. This is sometimes to the advantage of the Revenue and sometimes the taxpayer.

C.2.1.2 Defence of the Rule

Viewed in this light, it is seen that the deemed market value consideration rule operates simply to accelerate the time at which capital gains tax is payable. Nor does the acceleration seem altogether unjust when one bears in mind that the capital gains tax legislation allows an arguably unjustifiable deferral of tax on accrued capital gains. For while those in receipt of income are, by and large, transfer, the termination of the "relevant property" trusts gives rise to an exit charge and, at some later stage, which will depend on the precise variant of the strategy employed, there will be a potentially exempt transfer which might retrospectively become chargeable. Moreover, if the settlor dies at any time before the potentially exempt transfer, then there will be a charge to inheritance tax in respect of the settled property, whether under the gifts with reservation of benefit provisions or otherwise.

Their Lordships also relied, as an independent reason, on the fact that income arose under the trust which belonged to the mother and was either taxed as hers or would have been taxed as hers but for being taxed as the daughter's by virtue of the income tax Settlement provisions, contained in Income and Corporation Taxes Act 1970 Part XVI. On the basis that the settled property will produce a more than nominal net income during the "relevant property" period, the condition will be satisfied here too. (The income will not in fact belong to the settlor but will be deemed to be his for income tax purposes by virtue of Taxes Act 1988 Part XV (Settlements).)

8 Conclusion

In my view, the use of a revocable settlement can be an effective way of obtaining hold-over relief from capital gains tax. It is normally suitable only where the donor is content that the gifted property should remain settled indefinitely. Considerable care needs to be taken in drafting the settlement.

obliged to pay tax year by year, the holder of a capital asset can enjoy all the benefits of its increase in value without any charge to tax unless and until he disposes of it. He may obtain an increased income from it or enjoy it *in specie.* He may even indirectly realise the gain by borrowing on the security of it.

Of course, a system under which capital gains tax was charged each year on the rise in value of capital assets would in practical terms be so oppressive as to be unworkable. And this accords with our conservative accounting instincts which tell us to count no increase in value as a gain until it is realised. Nevertheless, the recognition of an accrued gain on a disposal by way of gift presents fewer practical difficulties. True, there may be cash flow difficulties in that the transaction itself will not generate the cash with which to pay the tax. (And this is perhaps the best argument in favour of the derogation from the market value consideration principle introduced by hold-over relief.)

From a theoretical point of view, too, there are less difficulties. The analysis is that the donor has in effect realised his gain and gifted it to the donee. If the donor and the donee complain that the donee has received less than the donor has given, this is simply because the asset was never really (in its entirety) the donor's to gift at all. Although its gross value constituted an asset of his estate, it was in effect charged with the capital gains tax payable on a disposal. The Crown has simply claimed its own. The simple analysis is inadequate where the donee is, as between donor and donee, ultimately liable for the tax. Where the donor is ultimately liable for the tax and pays it out of other funds, the further analysis is that he has in effect made an additional gift of those funds to the donee. This is realistic only if the donor is aware of the consequences of his actions.

The capital gains tax system places a heavier burden of tax on those who make frequent disposals and acquisitions of assets as compared with those who retain assets long-term. The maxim that tax deferred is tax saved has, in actuarial terms, an enormous amount of truth in it. That is why capital gains tax efficient systems, such as non-resident trusts which may in fact only defer payment of capital gains tax, are nevertheless perceived as being, in practical terms, instruments of capital gains tax avoidance. If the market value consideration rule did not apply to gifts, then the same property could be handed down from generation to generation of a family growing steadily richer without any charge to capital gains tax. Moreover, the capital gains tax advantages of retention of the same assets, as compared with their sale and reinvestment of the proceeds, might be thought to be economically undesirable.

C.2.2 History of Hold-Over Relief on Gifts

C.2.2.1 Overview

When capital gains tax was first introduced, in 1965, the market value consideration rule held sway. Over the years, derogations were made from the principle by the introduction of hold-over relief on a piecemeal basis. The legislation reflected the power of political pressure groups at the time. For example, working farmers were particularly favourably treated. When Mrs Thatcher came to power, the agglomeration of provisions was contained in what is now Taxation of Chargeable Gains Act 1992 section 165 and Schedule 7. By Finance Act 1980, a general hold-over relief was introduced for gifts to individuals. By Finance Act 1981, this was extended to gifts to trusts. By Finance Act 1982, this was further extended to disposals by trustees to beneficiaries. The only real limitation on the relief was that the donee or beneficiary must be resident or ordinarily resident in the UK. That was clearly essential in order to prevent widespread avoidance of tax. For the same reason, an emigration charge was introduced by Finance Act 1981 where the donee ceased to be resident or ordinarily resident in the UK after receipt of the gift. Section 165 and Schedule 7 were not dismantled but were left to apply only to gifts to UK resident companies. Given the prohibition on emigration of such a company imposed by Taxes Act 1988 section 765, it was not thought necessary to impose a charge where a donee company subsequently emigrated.

C.2.2.2 Philosophy

Mrs Thatcher's philosophy in introducing a general hold-over relief was that taxpayers should not be taxed on "artificial" gains. As with many of the Thatcher tax reforms, the ostensible purpose was to promote enterprise, yet the real winners were families holding passive investments or tangible property held for their own use which were passed down from generation to generation.

C.2.2.3 Tax Avoidance

The general hold-over provisions were not accompanied by sophisticated anti-avoidance legislation. For years, a variety of tax planning strategies were used which depended for their efficacy on the availability of such relief. The Inland Revenue must have been fully aware of these strategies which were openly discussed at seminars and treated in textbooks as constituting "soft" tax avoidance. It was the introduction by Finance Act 1988, however, of different rates of capital gains tax that opened up the prospect of more widespread use of hold-over relief in capital gains tax planning.

C.2.3 Finance Act 1989 Restrictions on Hold-Over Relief

The reaction in the 1989 Budget Speech was electrifying. General hold-over relief was to be abolished. Donors were to be taxed on artificial gains. Taxation of Chargeable Gains Act 1992 section 165 and Schedule 7 were to be restored, with modifications, to their former grandeur. There was to be a return not to Victorian but to Socialist principles! This response to the problem of avoidance was pathetic. If the possibilities of avoidance which hold-over relief opened up were unacceptable, then it was incumbent on the Revenue to legislate so as to close them up. That could easily have been achieved by leaving hold-over relief intact but by introducing a few simple anti-avoidance provisions. For example, where the donee claims some exemption or relief on the disposal by him of the asset gifted, in determining whether and if so to what extent relief was available one would have regard to the combined period of ownership of the donor and the donee. This would have been particularly appropriate to the principal residence exemption and roll-over relief on replacement of business assets. If the tax advantage obtained was a reduction in the rate of capital gains tax chargeable on the ultimate disposal, the held-over gain could then be taxed at the donor's rate.

Instead, rather like religious fundamentalists rejecting the westernisation of their state, the answer has been to abolish the reforms of the early Thatcher years and to go back to the old ways. The result? Those who are fortunate enough to find that hold-over relief is still available, namely traders, farmers, passive investors in unlisted trading companies and those who can afford sophisticated tax advice, can scheme to avoid tax just as much as before. Those persons who are wicked or foolish enough to hold their wealth in such objectionable forms as quoted securities, tenanted accommodation or secondary homes will now indeed find that on any gift they will be taxed on unreal gains. The new rules represented a complete volte-face by the Thatcher administration.