The Personal Tax Planning Review

SHEARING AND REVERSIONARY LEASES

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Introduction

"Shearing" has long formed part of the lexicon of those advising clients on inheritance tax. It describes the process by which an intending donor who wishes to retain some measure of enjoyment related to the property to be gifted carves out (or shears off) an interest conferring on him the right to that enjoyment and thereafter gifts the property subject to that interest, so reducing the value of his inheritance tax estate by means of a potentially exempt transfer. It is hard to improve on a metaphor based on what happens in sheep farming.

The object of "shearing" exercises is to circumvent the "reservation" of benefit rules in section 102 Finance Act 1986. The statutes relating to estate duty[2] contained rules which used (very largely) an identical form of words and had a broadly similar effect. So on the enactment of section 102 there became available to those advising on its scope a wealth of reported cases providing an indication of the construction likely to be placed on the new provisions by the Courts called on so to do. The estate duty cases established that what a donor of property retains does not form part of the subject matter of the gift; the property or interest retained is not, if one likes, part of the gifted property. So the benefit enjoyed by the donor by virtue of his retained interest was not a benefit reserved. The leading cases usually cited are *Munro v Commissioner of Stamp Duties for New South Wales* [1934] AC 61, *Commissioner of Stamp Duties of New South Wales v Perpetual Trustee Company Limited* [1943] AC 425 (both of which concerned New South Wales statutes being identical in effect to the United Kingdom statutes) and *St Aubyn v A-G (No 2)* [1952] AC 15. It did not matter whether what the donor

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2 See, amongst other provisions, section 2(1)(c) FA 1894 incorporating section 38 Customs and Inland Revenue Act 1881.

retained was the entire beneficial interest in a part of his property, the remainder being the subject of the gift, or whether what he retained was merely an interest in property which was thereafter gifted subject to that interest. In either case (1) the enjoyment and benefit which the donor had by virtue of the interest or property which he retained did not detract from the possession and enjoyment by the donee of the gifted property, and (2) the subject matter of the gift was to be regarded as retained by the donee to the entire exclusion of the donor or of any benefit to the donor by contract or otherwise.

The use of "shearing" is by no means limited to gifts of land. The controlling shareholder in a company, for example, who intends to gift the major part of his shares may wish to continue to enjoy a salary and other benefits which his controlling shareholding previously guaranteed. He may be unwilling to rely on the practice described in a Revenue Press Release of 19th February 1987 that the Revenue do not regard the payment of remuneration to a donor shareholder as a reservation of benefit if it is part of a "commercially justifiable" remuneration package. So his first step is to procure the company to enter into a service agreement with him which binds the company to pay him remuneration by reference to a fixed formula which is in no way dependant upon a subsequent agreement or the discretion of the Board of directors and then to gift the shares. But most shearing exercises are carried out by intending donors of houses or land.

The scope of shearing operations is constrained by the end result which the donor wishes to attain. The interest retained must give to the donor a right to enjoy the property (as in his hands) free of rent or other consideration for a period corresponding to his life expectancy or some shorter period during which he wishes to live in or otherwise enjoy the property. Enjoyment of the property can be preserved by a "lease for life" or a settlement conferring on the donor an interest in possession. No "reservation of benefit" problems arise in such cases. The subject matter of the gifts will be the freehold subject to the lease for life or the reversionary interest in the settlement. But such arrangements save not one penny piece of inheritance tax. The property will remain comprised in the inheritance tax estate of the donor so long as his interest (or lease for life) subsists.[3] If the shearing exercise is to achieve its object the interest retained must not have the status of an "interest in possession".

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3 Sections 43(3) and 49 Inheritance Tax Act 1984.

Shearing - *Ingram v IRC*

The best known means deployed both in the days of estate duty and since the enactment of section 102, have been for the intending donor to first carve out the interest he or she is intending to retain and then to give the property subject to that interest. Commonly the retained interest will consist of a lease of the entire property having a term of years corresponding to what is thought to be the life expectancy of the donor. But the retained interest can also comprise some lesser interest: for example, the retention of a right to shoot or fish - or a lease over any part of the gifted property.

Intending donors wishing to take this course have usually been faced with one or perhaps two hurdles. The first of these is likely to arise to a greater or lesser extent in every case. It is best illustrated by the decision of the House of Lords in *Rye v Rye* [1962] AC 496 - a case which had nothing whatever to do with taxation - which confirmed[4] that it was not possible for a person lawfully to grant a lease to himself. Accordingly, leases purportedly so granted are void and of no effect. In *Rye v Rye* the question was whether two owners of land could grant a lease to themselves as partners. The principle would apply *a fortiori* where a single person was purported to grant a lease to himself. This might loosely be called the "conveyancing hurdle".

The Revenue successfully raised the conveyancing hurdle in the field of taxation in *Kildrummy (Jersey) Limited v IRC* [1990] STC 657 where the Court of Session held that a nominee could not grant a lease of Scottish land to individuals for whom it held as nominees. In *Ingram v IRC* [1995] STC 564 the High Court arrived at the same conclusion in relation to land in England, albeit by a somewhat circuitous route, but held that what had been ineffective as a grant of a lease at the time it was made took effect as a lease on the gift of the land to the donee trustees since those donees took the land as volunteers and on the basis that it was subject to the lease in favour of the donor (Lady Ingram).

The second of the two hurdles was (effectively) raised by the Revenue in *Ingram v IRC*, relying very largely on *dicta* in *Nichols v IRC* [1975] STC 278. The Crown relied on the *dicta* as being of particular application to the facts of Lady Ingram's case but "made it clear that there was no challenge in [Lady Ingram's case] to the well established position in which the existence of an express or implied reversionary interest in favour of the donor is not regarded as a reservation of benefit" (page 580h). However, the judgment of Goff J (delivered in the judgment to the Court of Appeal in *Nichols*, whilst no doubt directed to the facts

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4 In the sense that there was any conflict of authority prior to that decision.

of the case, went somewhat wider. It is the width of the judgment which has given rise to the problem. The passage is at pages 284 to 285:

> "Having thus reviewed the authorities, we return to the question what was given, and we think that a grant of the fee simple, subject to and with the benefit of a leaseback, where such grant is made by a person who owns the whole freehold free from any lease, is a grant of the whole fee simple with something reserved out of it, and not a gift of a partial interest leaving something in the hands of the grantor which he has not given. It is not like a reversion or remainder expectant on a prior interest. It gives an immediate right to rent, together with a right to distrain for it, and, if there be a proviso for re-entry, a right to forfeit the lease. Of course, where as in *Munro v Commissioner for Stamp Duties (NSW)* [1934] AC 61, the lease, or as it may have been, a licence, with an interest, arises **under a prior independent transaction**, no question can arise because the donor then gives all he has, but where **it is a condition of the gift that a leaseback shall be created**, we think there must, on a true analysis, be a reservation of a benefit out of the gift and not something not given at all." (My emphasis added).

Nichols involved a shearing exercise which failed, with the consequence that estate duty became payable on the death of the donor in respect of the gifted property on the grounds the donor had reserved a benefit. In *Nichols* the lease had not been granted to the donor at the date of gift. The Court of Appeal held that the arrangement between the donor and donee was such that the donee received the estate in fee simple in law and in equity "but subject to an obligation binding in equity to grant the leaseback". In other words there was something which the donor was able to enforce. The distinction between the facts in *Nichols* and the more normal "shearing" operations is that in *Nichols* something remained to be done by the donee, which was to grant the lease back to the donor - a grant which took place one month after the date of the gift. Although the property in *Nichols* was gifted subject to the equitable obligation of the donee to grant the lease-back, it was not expressly subject to the lease as an item of property or interest in property since it had not been granted to that date. The position was as if the farmer had sold the sheep without first shearing off the wool. The fact that he was in the position to require the buyer of the sheep to shear off the wool and return it to him did not mean that the sheep had been sold shorn of the wool in the first place.

The hurdle confronting those wishing to engage in shearing operations as part of a gift lies in the words first emphasised, which suggest that the Court considered it requisite that the licence or interest which the donor reserved should arise "under a prior independent transaction". What is meant by an "independent transaction"?

Does the independence of a transaction mean that it must be independent in the sense that it is not made in contemplation of a later transaction or event? Or does it bear a more restricted meaning: *viz* that a transaction only loses its independence if it is linked with a later transaction or event either in the sense that it is conditional on that transaction or event or is contractually linked?

Now in *Ingram*, in common with all similar shearing exercises, the interest retained did not come into being as a consequence of a "prior independent transaction" in the first sense. Lady Ingram would not have entered into the lease or caused her nominee to grant the lease (as she had assumed at the time) if she had not been contemplating a gift of the freehold subject to the lease. It is equally clear, however, that she was in no way bound to make the gift of the freehold following the execution of the purported lease and that whilst the lease did not take effect until the equitable interests in the property (the freehold and the lease) were severed following the grant of the purported lease, the lease itself was in no way conditional on the gift of the freehold. By contrast, the grant of the lease in *Nichols* was plainly linked to the prior gift of the freehold. In *Ingram*, the second, more restrictive meaning of "independent transaction" appears to have been adopted and the taxpayer's appeal succeeded. However, the Revenue are pursuing an appeal to the Court of Appeal. The validity of the arguments of the taxpayer in applying and adapting the principles established in the estate duty decisions to the provisions in section 102 has therefore to be tested anew.

It may well be that the Crown will not seek to argue that "independent" has other than the more restricted meaning as a prior transaction independent of some obligation or condition to which the later gift is subject. That would seem to follow from the acceptance by the Crown (at 580h) that there was no challenge to the "well established" position in which the existence of an express or implied reversionary interest in favour of the donor is not regarded as a reservation of a benefit. Likewise, one would have thought that the existence of a prior interest consisting of a lease in favour of the donor was not to be regarded as a reservation of benefit. Support for the proposition that this may indeed have been the view of the Court of Appeal in *Nichols* is found in the passage secondly emphasised above in which the Judge contrasts the "prior independent transaction" with the case "where it is a condition of the gift that a leaseback shall be created" (as is the case in *Nichols*).

Alternatives

Until *Ingram* is finally determined in favour of the taxpayer doubts will remain as to whether the classic shearing exercise of which *Ingram* provides a not untypical illustration works. What alternatives are open?

(1) Where an intending donor can find a willing collaborator (say, husband or wife) no insuperable problems are posed by *Kildrummy (Jersey) Ltd* or *Ingram*. The lease to be retained would initially be granted by the donor (or the trustee or nominee for the donor) to the donor and the collaborator jointly. The lessees will not, of course, take jointly but as tenants in common holding the lease in different shares. There can be no question that a person being the owner of the legal and equitable estate in property can grant a lease of that property to himself and another jointly and a lease so granted would be valid and enforceable from the date of grant. But in many cases (and doubtless *Ingram* was one) a willing collaborator may not be available - not least because the co-tenants will be jointly liable under the covenants contained in any lease. For such persons the conveyancing obstacle raised in *Ingram* remains.

(2) The intending donor may abandon his intention of making a gift and instead sell the freehold reversion subject to a retained lease for full value. This operation would involved no "gift". So the reservation of benefit provisions in section 102 are of no consequence. A saving of inheritance tax will be achieved on the death of the lessee because the retained leasehold interest will be worth that much the less on the death of the lessee. It has that in common with *Ingram*. But a sale of the reversion is unlikely to be attractive to those wishing to save inheritance tax because it results in no immediate diminution in the estate of the transferor. And - in common with all shearing exercises - they leave the purchaser/transferee with a substantial potential liability for capital gains tax on disposals on a gain attributable not merely to the inflationary increase in the value of the freehold but also to increases reflecting the diminishing value of the lease.

(3) An intending donor can retain possession and enjoyment of gifted property such as land or house without falling foul of the reservation of benefit provisions in section 102 by gifting the same and by agreeing to pay the full market rent therefor (para 6(1)(a) Schedule 20 FA 1986). That will get the value of the freehold reversion out of the (inheritance tax) estate of the donor at once. Since the freehold is to be subject to a lease at a rack rent one can assume that almost the entire value will go out of the donor's estate and escape the charge to inheritance tax subject to his or her surviving the seven year period.[5] This form of "shearing" is of limited utility. In order to secure that the potentially exempt value transferred (not being entitled to relief as attributable to agricultural or business property) retains its exempt status, the donor must live for seven years. During that time the full market rent will have to be paid. If - as might be the case

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5 It is assumed for these purposes that it is a potentially exempt transfer.

with, say, agricultural land on which the donor carries on a trade - the rent is deductible in arriving at the donor's profits for tax purposes, this presents no great problem. But more commonly the subject matter of a gift comprises the residence of the donor. In those cases the charging of a rent will create a source of income subject to tax when none existed before with no deduction in arriving at taxable income. The overall loss would be limited in cases if the recipients of the income are not liable to income tax thereon (e.g. because it falls within the personal reliefs available to them).[6] But even in cases where the payment of rent does not occasion an income tax charge, the resources available to a donor may not permit the payment of rent and, as with shearing exercises of the kind considered in *Ingram*, the gains[7] accruing on disposals by the donees will be the subject of a charge to capital gains tax since in no case will the principal residence exemption be available to them. The gifted interest which will be the subject of a chargeable transfer on the donor's death within seven years is far more valuable (and the potential charge to inheritance tax far greater) than an interest subject to the right of the donor to enjoy the property concerned for a nominal consideration only. In the conventional shearing operation the donor retains a valuable property - *viz* the interest which confers on him the right of enjoyment. But this interest is of diminishing value and will be worth correspondingly less on his death within the seven year period than at the beginning of that period.

(4) The donor may give the property or an interest in possession in the property (say, his dwelling) to his or her spouse. It is arguable that the act of the donee spouse in permitting the donor to enjoy the gifted property in the normal course of their marital relationship, does not confer a "benefit reserved" on the donor for these purposes.[8] The objections to this are predictable. If the donee spouse dies first, the donor can only continue in his or her enjoyment of the gifted property by paying a full rent or other consideration - if the reservation of benefit trap is to be avoided. The gifted property will in any event swell the donee spouse's inheritance tax estate and thus risks attracting a charge on his or her death. Taken by itself, the exercise has in any event little point since exemption from inheritance tax (under section 18 Inheritance Tax Act 1984) can be

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6 As is often the case with grandchildren. There may be a case for spreading the benefit of the gift of the freehold reversion amongst as many donees as possible.

7 The gains will be less than in "shearing" operations because the base value of the gifted property will not be subject to a valuable retained interest.

8 The authority is *A-G v Seccombe* [1911] 2 KB 688.

as well enjoyed by gifting the property to the spouse by will as by a lifetime transfer. At best the contention that no benefit is reserved in such cases is arguable. No assurance can be offered that it works.

Some of the objections to (4) may be overcome by gifting the property not merely to the spouse of the donor but the spouse together with other beneficiaries such as the children of the donor. That will serve to keep the interests of those other than the spouse out of the spouse's inheritance tax estate. But it leave unresolved the question as to what is to happen on the death of the donee's spouse prior to the donor. Furthermore, the remaining donees, unless they too live in the property as a principal residence, will be faced with the same capital gains tax problem as donees renting the property to the donor for a market rent.

Reversionary Lease

With the limited range of alternatives a variant of the shearing exercise which is largely immune from the contentions deployed by the Revenue in *Ingram v IRC* has found some favour. This is the so-called "reversionary lease" scheme. It is in some respects the converse of the more typical shearing scheme considered in *Ingram*. Under the "reversionary lease scheme" an intending donor who wishes to continue in the active possession and enjoyment of land or buildings (typically his residence) whilst divesting himself of a major portion of its value will grant to the intending donees a lease the term of which will commence at the end of a period not being more than 21 years hence but which will otherwise correspond to what is then thought to be the donor's life expectancy.[9] The lease will be for a term of 999 years or any shorter period calculated to exhaust in large part the value of the property once the term commences. The rent reserved will be a peppercorn or some nominal rent. The donor as the owner of the freehold reversion which he or she has retained remains entitled to possession and enjoyment of the land or buildings in his or her capacity as freehold owner pending the commencement of the term granted. The reversionary lease scheme is free of the objections to the more typical shearing exercise under consideration in *Ingram*:

(1) There is no question of the donor granting a lease to himself (whether alone, as is more typical, or with other persons);

(2) There is only one transaction: the grant of the lease. The interest retained is quite simply not part of the property gifted. The gifted property - that

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9 The limit of 21 years is necessitated by section 149(3) Law of Property Act 1925 under which a lease commencing more than 21 years after the date of grant is of no effect.

is, the reversionary lease - is enjoyed to the entire exclusion of the donor and of any benefit to him by contract or otherwise.

Does it work?

The reversionary lease scheme is not wholly immune from attack under the reservation of benefit rules.

"Property subject to a reservation" in section 102 is a compendious expression describing two or perhaps even three sets of circumstances in which a supposed benefit may be reserved to the donor out of the gifted property.[10] In particular, a benefit will be reserved in all cases where "possession and enjoyment of the property is not *bona fide* assumed by the donee" at or before the date of the gift (section 102(1)(a)). "Shearing" exercises of the *Ingram* type do not result in a benefit being reserved under this provision. The freehold reversion expectant on the determination of the lease retained by the donor is the only "property" given and full and immediate possession of **that** property is assumed immediately by the donee on the making of the gift. It is of the essence of the reversionary lease scheme that actual possession and enjoyment of the subject matter of the gift **as a lease** is deferred for a period of up to 21 years. Does that then mean that the reversionary nature of the lease gifted is fatal to the efficacy of the scheme as a whole? In my view, the answer is "No". Enjoyment of the lease in the sense of entitlement to receive rent from sub-lessees or physical possession is postponed. But the subject matter of the gift is not the lease itself but a reversionary lease the term of which is not to commence until some time in the future. Immediate possession and enjoyment of **that interest** is had by the donee from the date of the gift. Support for the proposition that no benefit is reserved in such cases is found in the judgment of Harman LJ in *Re Harmsworth, Barclays Bank Ltd v IRC* [1967] Ch 826. The Revenue sought to contend that property comprised in a settlement made by Lady Harmsworth in which she had retained a life interest "passed" on her death and accordingly became the subject of a charge to estate duty. The claim that the property passed under section 2(1)(b) Finance Act 1894, on the ground that Lady Harmsworth had an interest in possession, failed as the settlement made by her had been made for a consideration (to satisfy a condition of her becoming entitled to an annuity under her husband's will). The Revenue claimed alternatively that the settled property was dutiable because Lady Harmsworth as a donor had "reserved a benefit" either (a) because she had retained a benefit consisting of the annuity "by contract or otherwise", or (b) because she had retained the benefit consisting of the life interest in the settlement made by her. The Revenue succeeded in their contention at (a). They persuaded

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10 See the closing words of section 102(1).

Lord Denning as to the correctness of both (a) and (b) but Lord Denning in his judgment combined his views on (a) and (b). Harman LJ addressed himself specifically to the question of whether possession and enjoyment (finding for the Revenue on (a)) of the gifted property had been obtained by the donee. He said at page 857:

> "As I have said, this must be treated as a gift. It is difficult to see how possession and enjoyment of an interest in remainder can be taken immediately on the gift, but I think that these words are satisfied because here the husband's relations as donees became the absolute owners of the remainder from the day the gift was made and could dispose of it or charge it, and the donor, that is to say Lady Harmsworth, had no more interest in it. So far the mischief of the section of the section is avoided, but there remain the words "or of any benefit to him by contract or otherwise". Here the benefit to the donor was the annuity which she obtained by contract or something in the nature of a contract..."

It is clear that immediate possession and enjoyment of the subject matter of the gift is had by the donee where that subject matter is a reversionary interest under a settlement expectant on the determination of a prior interest. The contrary argument is open to objections other than those considered in the passage of Harman LJ cited above. The gifted property which the donee enjoys is, after all, the reversionary interest - not the trust fund, still less the investments therein. These additional contentions lose their force when applied to the "reversionary lease". One does, after all, expect a lessee to have some measure of possession and enjoyment of the property gifted - that is, the lease. Yet under the reversionary lease possession and enjoyment of the actual property gifted is postponed. But my preferred view is that in such cases immediate possession and enjoyment of that which is given is obtained by the lessee/donee. To adopt the words of Harman LJ: the lessee can sell, charge or otherwise dispose of his reversionary interest during the time it is reversionary. The donor, by contrast, can only dispose of the freehold reversion subject to the agreement for lease.

Reversionary Lease - Capital Gains Tax

So far, so good. But what of capital gains tax? Under the "reversionary lease" scheme the donor will have retained an asset (i.e. the freehold) whose value as a marketable asset will diminish progressively as the date for the commencement of the reversionary lease falls near. This freehold is not a "wasting asset" for the purposes of capital gains tax. Accordingly, the residual base cost attributable to the freehold which remains after that attributed to the part-disposal on the grant of the lease has been taken into account does not fall to be written off. So the likely

result of a reversionary lease scheme is to generate a capital gains tax loss on any subsequent disposal by the donor of his interest. To that extent, the reversionary lease scheme is more beneficial to the donor than the more conventional kind of shearing exercise under consideration in *Ingram*. The retained lease in such cases will be a wasting asset and the base cost is liable to be written off,[11] so restricting, if not eliminating, any possibility of claiming an allowable loss on the disposal. But the supposed capital gains tax advantage to the donor arising from the reversionary lease scheme is largely illusory. The invariable object of all these schemes is to enable a donor to enjoy the retained interest (whether it is a freehold or leasehold) until his or her death. On that date, there will be an acquisition of the retained interest for a consideration equal to whatever is then its market value but no corresponding disposal occasioning a loss which can be set off against any gains which have accrued in the lifetime of the donor.[12] In the majority of cases involving shearing operations the asset will, in any event, comprise the principal private residence of the donor. So if the dwelling falls to be sold between the date of gift and the date of the donor's death, the consequential loss in respect of the donor's interest will not be an allowable loss for capital gains tax purposes.

The capital gains tax position of the donee, by contrast, is very different. Both under the more conventional shearing exercise considered in *Ingram* and under the "reversionary lease" scheme very substantial chargeable gains will accrue to the donee on any subsequent disposal of his or her interest in the land given. Take first the more normal case where the lease is first shorn off the freehold and the reversion gifted subject to that lease. Here the donee will acquire an asset, the market value[13] of which will reflect the value of the retained interest. It will be modest by comparison with what its value would have been if there had been no retained interest. If and when the donee comes to sell the reversion, the gain which accrues to him or her will reflect not merely increases in value attributable to such matters as market forces or inflation or, perhaps, the grant of planning permission, but also the enhanced value of the freehold attributable either to the extinguishment of the term reserved by the retained lease or the diminished length of that term, as the case may be. If, as would not be unusual, the residue of the leasehold term was gifted to the donee in the donor's will, he or she would, of course, have two elements in the base capital gains tax cost which would be brought in under section 43 Taxation of Chargeable Gains Act 1992. One would

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11 Schedule 8 to the Taxation of Chargeable Gains Act 1992.

12 Section 62(2) Taxation of Chargeable Gains Act, allowing allowable losses sustained by an individual in the year of assessment in which he dies to be set off against chargeable gains accruing in the previous three years is obviously of no assistance here.

13 Section 17 Taxation of Chargeable Gains Act 1992.

be the market value of the freehold at the date of the original gift (diminished to reflect the value of the lease); the other would be the market value of the residue of the term which would have a considerably diminished value by the date he acquired it under the disposition taking effect on the death of the donor/lessee.

Next take the reversionary lease scheme. Here, of course, the rules in Schedule 8 Taxation of Chargeable Gains Act 1992 requiring the writing-off of the market value of the lease at the date it is granted can be disregarded. Such leases will invariably be for more than 50 years. However, at the time the lease is granted it will inevitably have a low market value, for the term granted will not commence until the expiration of a period from the date of acquisition which may be as long as 21 years after the date of gift. When the lessee comes to dispose of the lease, therefore, a substantial chargeable gain - not entirely dissimilar to the sort of gain which accrues to the donee of the freehold reversion under the more conventional shearing scheme - will accrue, reflecting the increase in the value of the leasehold interest flowing from the closer proximity of the commencement of the term or the commencement of the term if indeed that has taken place. If the donor gifts the freehold reversion to the donee, the value of the freehold at the date of that gift will reflect the existence of the reversionary lease and, the closer that reversionary lease is to commencement, the smaller will be the value of the freehold. The aggregate base cost available to the donee on computing gains on later disposals under the provisions of sections 38 and 43 Taxation of Chargeable Gains Act 1992 will be substantially less than, for example, the market value of the vacant possession value of the freehold either at the original date of gift or at the date of the donor's death.[14]

The enhanced charge to capital gains tax on the donee of property which has been the subject of a shearing operation on the gift will only be of concern in cases where the donee himself intends to dispose of the gifted property. Where the donee is unlikely to dispose of the gifted property, the saving of inheritance tax will outweigh the marginal risk of an enhanced charge to capital gains tax should circumstances or a change of mind compel a sale of the whole or part of the gifted property by the donee. Such would be the case with large landed estates such as country houses and their gardens and grounds (to the extent that these do not qualify for relief as agricultural or business property). In many such cases the intention of the donee, who is usually the intended heir of the donor, is to retain

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[14] If, as is likely, the donor is looking to abandon his possession and enjoyment of the retained interest and gifts it to the donee and the donee is a connected person, any allowable loss accruing can only be set against gains accruing on the disposal of other assets to the donee (section 18(2) Taxation of Chargeable Gains Act 1992). These cannot include gains accruing on the disposal which will take place when the gift was made several years before.

the property gifted to him or her as property held in the family from generation to generation and any disposals are likely to be of relatively small value.

What of cases where it is likely that the donee will wish to sell?

Capital Gains Tax - possible solutions?

In the comparatively rare case where the donor is not resident or not domiciled in the United Kingdom, the charge to capital gains tax a on subsequent disposal of the gifted interest by the donee can be avoided by settling the gifted interest on non-resident trustees. Disposals by those trustees escape the charge to capital gains tax under section 86 Taxation of Chargeable Gains Act 1992 (settlements in which the settlor - or his wife or children - retain an interest) and the charge on capital payments received by United Kingdom resident and domiciled beneficiaries imposed by section 87 of that Act.[15] However, a non-domiciliary will normally have gone down the more usual route of escaping inheritance tax by a transfer of the United Kingdom property in exchange for shares in a company incorporated and resident outside the United Kingdom and then settling the shares. The shares will have status as excluded property and inheritance tax is, therefore, unlikely to be of concern. Where the donee individuals are not resident in the United Kingdom there will, of course, be no capital gains tax charged on disposals. Where the intended beneficiaries are resident but not domiciled in the United Kingdom, a United Kingdom resident and domiciled settlor would be advised to gift the reversionary lease or other interest to non-resident trustees of a settlement made for the intended beneficiaries who, by virtue of their domicile, can receive the capital payments following the realisation of a gain free of the charge to capital gains tax otherwise imposed on UK domiciled and resident beneficiaries under section 87 Taxation of Chargeable Gains Act 1992.

But intending donors with large houses who (or whose children) have a domiciliary or residential status which enables them to take advantage of the various escape routes left for persons who are either not resident or not domiciled outside the United Kingdom are a minority. The majority who are likely to benefit from shearing exercises are persons whose and whose family's domiciliary and residential status is likely to leave the whole of any chargeable gain accruing on disposals exposed to the charge to capital gains tax. For the donees of such persons the principal private residence exemption in section 222 is not available. Where, however, the donee is prepared to live in the property which is the subject matter of the gift as his or her principal private residence, the reversionary lease -

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15 It is assumed for these purposes that the settlor will have retained his non-resident or non-domiciled status at the date of disposal or earlier death.

coupled with the gift of the freehold reversion to the donee on the death of the donor - is to be preferred to the more conventional shearing exercise employed in *Ingram*. If the freehold expectant on the determination of the reversionary lease is given to the donee holding the lease, the lease gifted to the donee and the freehold will merge and the reversionary lease will be extinguished. If, after the freehold reversion vests in the donee, the donee lives in the house and land as his or her principal residence for the period of his or her ownership of the freehold, it is at least arguable that the gain accruing when he or she comes to dispose of the freehold interest will qualify in full for exemption under section 222. During his or her period of ownership of the reversionary lease, the property has not been his or her principal residence. But it has been his or her principal residence during his or her period of ownership of the freehold and it is of the freehold which he or she is disposing, not the reversionary interest which is merged with the freehold and been extinguished. Be warned! This argument is particularly dependent on the contention that the "period of ownership" does not include the prior ownership of the reversionary lease. Judges called on to construe this provision may be persuaded to adopt an interpretation of the "period of ownership" to include ownership of an interest which is merged into the interest disposed of and been extinguished, even if such a construction does, of necessity, involve the supplying of additional words to give effect to what the Court perceives to be the intention of Parliament.

The foregoing advantage is not enjoyed by the donee of the freehold reversion in the donor's principal private residence gifted under the more conventional shearing exercise. In such cases, the period of ownership of the interest disposed of - the freehold reversion - will commence with the gift and not at some subsequent date. So little will be gained by a donee (to whom the retained lease has been gifted) living in the principal private residence following the death of the donor with a view to gaining the principal private residence exemption.