The Personal Tax Planning Review

IRRELEVANT PROPERTY SETTLEMENTS

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Controversy has arisen over Robert Grierson's Article "Delayed Reaction" which appeared in *Taxation 1995* [134] 3489, 399. Grierson suggests that there are circumstances in which an "exit charge" under s.65 of the Inheritance Tax Act 1984 ("IHTA") may be postponed. Some support for Grierson's view may be found in *McCutcheon on Inheritance Tax*, Third Edition, at paragraph 8-13.

This article will attempt to explain why it is that Grierson's understanding is flawed.

Thrown up in the air ...

Grierson argues that the interaction between s.81 IHTA and s.65 IHTA has the effect that property leaving, for example, a discretionary settlement to be held on the trusts of a separate interest in possession settlement will nevertheless remain relevant property for the purposes of s.65.

Section 65 provides:

> "(1) There shall be a charge to tax under this section -
>
> (a) where the property comprised in a settlement or any part of that property ceases to be relevant property (whether because it ceases to be comprised in the settlement or otherwise); ..."

Section 81 provides:

> "(1) Where property which ceases to be comprised in one settlement becomes comprised in another then, unless in the meantime any person becomes beneficially entitled to the property (and not merely to an interest in possession in the property), it shall for the

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> purposes of this Chapter be treated as remaining comprised in the first settlement."

"This Chapter" means Chapter III of Part III of the Inheritance Tax Act, which includes ss.58 to 85 of the Act.

The argument runs as follows:

(A) Although in fact passing into the second settlement, the property, by the operation of s.81, is treated as remaining comprised in what Grierson calls "the 'relevant property' settlement" and therefore it remains relevant property.

(B) Because the property in fact ceases to be comprised in the first settlement, the applicable words of the bracketed expression in s.65(1)(a) are "because it ceases to be comprised in the settlement", rather than the words "or otherwise" (the two being mutually exclusive); but s.81 operates to treat the property as *not* ceasing to be comprised in the first settlement - therefore on this argument neither set of words applies, so s.65 does not bite.

... And Shot Down

One only has to look at the definition of "relevant property" in s.58 IHTA to see why argument (A) fails.

Section 58 provides:

> "(1) In this Chapter "relevant property" means settled property in which no qualifying interest in possession subsists ..."

Clearly s.81 has no effect on the question as to whether property is relevant property or not, the only material factor being the nature of the interest which from time to time subsists in the property. Section 81 cannot alter the fact that under the second settlement an interest in possession will subsist in the property. The result of applying s.81 is simply that the property is treated as if *under the first settlement* the trusts on which it is held alter so that an interest in possession in the property is created.

Argument (B) also withers in the light of day: in that argument, full account is taken of the effect of s.81 when examining whether or not the first set of words ("... because it ceases to be comprised in the settlement ...") applies, but then s.81 is ignored when considering the words "or otherwise". But if the circumstances are not encompassed by the first set of words, then necessarily they are covered by the words "or otherwise". The two sets of words are not only mutually

exclusive, they are also collectively exhaustive. Furthermore, in his arguments Grierson conveniently ignores s.65(1)(b) which, if s.65(1)(a) were to fail to apply, would nevertheless impose a charge to tax.

Picking up the Pieces

Having concluded that there is no exit charge on property passing from a discretionary settlement to an interest in possession settlement, Grierson postulates that the tax will be recovered in the end, when the property leaves the interest in possession settlement on the occasion of a person becoming absolutely entitled. On that occasion, he says, the property will cease to be relevant property and so there will be a s.65 charge. This reasoning, essentially the corollary of the earlier argument (A), fails for the same reason as that argument, in other words because it is not the settlement in which property is held (or treated as being held) that determines whether or not it is relevant property, but rather the actual interest subsisting in it at any particular time.

It is merely an example of the general scheme of the Inheritance Tax Act that the settlement in which property may be (or be treated to be) is immaterial to the operation of s.65. The general scheme of the Act is that it is the nature of the beneficial interest in each item of property which determines its inheritance tax treatment, and not the broad nature of the settlement in which the property is included. See, for example, section 71:

> "this section applies to settled property if ... beneficiaries will, on or before attaining a specified age not exceeding twenty-five, become beneficially entitled to it ..."

It can be seen that Grierson's concept of "a 'relevant property' settlement" is thoroughly misleading.

Feet Firmly on the Ground

It is fortunate for the taxpayer that Grierson's arguments are misconceived, because the rate of charge under s.65 depends on the length of time which has elapsed since the commencement of the settlement (or, if more than ten years have elapsed, since the last ten-year anniversary). If the occasion of charge were to be delayed, the rate of charge would be higher. And if the property were to remain relevant property when an interest in possession subsisted in it then the ten-year anniversary charge provisions would continue to apply, a thoroughly undesirable (and illogical) result.

The true effect of s.81 on the operation of ss.64 and 65 is far more pedestrian. Section 81 comes into force when property leaves one discretionary settlement to

be held on the trusts of a second discretionary settlement, for example on the exercise of a power of appointment in the wider form (see *Bond v Pickford* [1983] STC 517, 523). In such circumstances the date of each ten-year anniversary, and the rates of charge under ss.66 to 69, continue to be calculated by reference to the first settlement. Furthermore, s.81 prevents trustees of a settlement from avoiding the ten-year anniversary charge and the exit charge altogether by continually resettling property immediately before the end of each quarter year.

On Grierson's view, the inheritance tax treatment of property which ceases to be held on discretionary trusts (or on any other trusts under which it is relevant property) is anomalous, since it is dependent on whether the property passes into a separate settlement or remains in the same settlement. We would suggest that instead of creating anomalies, s.81 has quite the opposite effect, of ironing out any differences that might otherwise have existed between the inheritance tax treatment of these two situations.