The Personal Tax Planning Review

GIFTS OF BUSINESS AND AGRICULTURAL PROPERTY TO DISCRETIONARY TRUSTS

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It is normally undesirable to make a gift to a discretionary trust, as it cannot constitute a potentially exempt transfer for inheritance tax purposes. Tax will be charged immediately, at a rate of 20%, subject to any reliefs, on the value transferred, once the transferor's nil-rate band has been used up. Lifetime gifts to discretionary trusts have thus in general been unattractive since potentially exempt transfers were introduced by FA 1986.

There is one situation, however, where, arguably, a gift to a discretionary trust, which constitutes a chargeable transfer, is actually better than a gift to, say, an interest in possession trust, which would constitute a potentially exempt transfer. This is where the transferor is unlikely to survive the seven-year period, where the gifted property is likely to be sold during his lifetime and that property qualifies for business property or agricultural property relief. While this possibility has existed since 1986, it has been made very much more important by the introduction of 100% business property and agricultural property relief by F(No. 2)A 1992.

Let it be supposed that a 30% holding in an unquoted trading company which has no "excepted assets" is proposed to be made. The company is likely to be sold within a few months. The prospective donor is terminally ill and has a life expectancy of only one to two years. He wishes to make a gift for the benefit of his son. If he makes an absolute gift to the son or gifts the property to the trustees of an interest in possession trust, he will have made a potentially exempt transfer. Let us suppose that the shares are sold within six months and are not replaced by other replacement property. The donor then dies two years after the gift.

The potentially exempt transfer thereupon becomes chargeable: Inheritance Tax Act 1984 s.3A(4). Yet does 100% business relief continue to be available? Section 113A, introduced by FA 1986, creates a problem. It provides that where

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a PET does become chargeable, business relief is not to be available unless certain conditions are satisfied. One condition is that the property originally gifted was owned by the transferee, in this case the son, throughout the period beginning with the date of the chargeable transfer and ending with the death of the transferor. That condition is clearly not satisfied.[2] Thus, when the PET becomes chargeable business relief is lost altogether.

Suppose, however, that the donor made his gift to a discretionary trust for the benefit of his son. The element of discretion need be only very small. For example, the son could be given an absolute interest subject to a power reposed in the trustees to pay income to charity instead of to the son for the next twenty-one years. The mere existence of this power would defeat the existence of an interest in possession and thus the trust would be taxed for inheritance tax purposes as a "relevant property" trust: Inheritance Tax Act 1984 s.58(1).

The gift to the trust is a chargeable transfer. 100% business relief is available, however. In the first instance, tax was to be charged at one-half of the death rate on the value transferred. Assuming the transferor to have used up his nil-rate band and annual exemptions, the rate would have been 20%. Of course, as the value transferred would have been reduced to nil by 100% business property relief, no tax would actually have become exigible: see s.7(2). Where, however, the transferor dies within three years s.7(2) is not to apply if s.7(4) applies. Where the transferor dies within three years of the gift, s.7(4) provides that the tax is to be charged on the value transferred at the full rate, in the circumstances envisaged, 40%. Now if s.113A had never been enacted, this would be of no consequence. The value transferred by the gift would remain at nil and it would not matter that the rate of tax exigible had been increased from 20% to 40%.

Section 113A deals with potentially exempt transfers and chargeable transfers in two quite separate subsections, namely subsection (1) and subsection (2) respectively. In the case of a potentially exempt transfer which becomes subsequently chargeable, there is no question but that the business property relief is retrospectively withdrawn *in its entirety*. In the case of a transfer which was initially chargeable, however, the position is arguably very different. Section 113A(2) provides:

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2 The condition does not have to be satisfied in every case. There are special rules where the transferee dies before the transferor, where there is a reorganisation to which TCGA 1992, sections 126 to 136, apply or where replacement property is acquired. Let us assume, however, that none of these exceptions is in point.

"Where -

(a) any part of the value transferred by any chargeable transfer, other than a potentially exempt transfer, is reduced in accordance with the preceding provisions of this Chapter,[3] and

(b) the transfer is made within seven years of the death of the transferor,

then, ... the additional tax chargeable by reason of the death shall be calculated as if the value transferred had not been so reduced."

Hence, s.113A(2) makes use of a statutory hypothesis. Such hypotheses constantly give rise to problems of interpretation. The rules applicable to them are in principle the same as those applicable to statutory deeming provisions. They have recently been reviewed by the Court of Appeal in *Marshall v Kerr* [1983] S/T/C/360.[4] Thus, one applies the statutory hypothesis literally unless to do so would result in injustice, anomaly or absurdity, or would be plainly outside the purposes for which the hypothesis was introduced.

Let us thus apply the statutory hypothesis. Suppose that on the original gift of the shares the value transferred had not been reduced by business property relief. How much tax would have become chargeable? The answer is clear: 20% of the value transferred. How much tax is chargeable by reason of the death? *Prima facie*, applying s.7(4), it is 40% of the value transferred. Yet s. 113A(2) does not look simply to tax chargeable by reason of the death but to "additional tax chargeable by reason of the death". Now if business property relief had not been available on the original gift, tax equal to 20% of the value transferred would have been payable on the *inter vivos* gift. Total tax equal to 40% of the value transferred would have become payable by virtue of the subsequent death and thus the *additional* tax chargeable by reason of the death is only 20% of the value transferred. Thus, it would appear that the gift becomes taxable at only 20% *in toto* by virtue of the subsequent death, whereas if the gift had constituted a PET, it would have become chargeable at the rate of 40%.

I very much suspect that this is a conclusion which the Capital Taxes Office would be unwilling to accept. Possibly, they might argue that one does not apply the statutory hypothesis strictly as that would give rise to absurdity or injustice. The

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3 i.e, Chapter I of Part V of the Act, which deals with business property.

4 At the time of writing, the appeal of the Revenue to the House of Lords has been heard but speeches have not been delivered. It appears, however, that the members of the Appellate Committee accept that the statements of principle as to the construction of deeming provisions made by the Court of Appeal are correct.

Revenue are known to take a much wider view than the courts as to what constitutes injustice. In many cases, this seems to amount to no more than less tax being payable than would otherwise be the case! Yet it is difficult to see why the word "additional" was inserted if the view Revenue would have to advance were in fact correct. If s.113A(2) had simply referred to "the tax chargeable by reason of the death", the position would have been entirely clear. One would have said that, because of the death, s.7(2) was no longer in point and s.7(4) came into play. That requires tax to be charged at the full rate of 40% on the whole of the value transferred, and s.113A(2) would then direct one to ignore business property relief in calculating the value transferred.

If the trusts remained discretionary during the lifetime of the donor, there would be the possibility of a periodic charge, albeit at a maximum rate of 6% every ten years of the value of the settled property. This could be avoided, in the circumstances hypothesised[5] by the trustees conferring an interest in possession on the son shortly before they entered into a binding contract to sell the shares. While that would be an occasion of charge if it occurred after the first quarter of the life of the settlement, 100% business relief should in principle still be available. It is irrelevant in the case of such a charge that the business property is sold shortly after the occasion of charge.

Naturally, in deciding whether to implement this strategy in any particular case, one must have regard to all the circumstances. Nevertheless, where events are very likely to happen in the order and within the timescale mentioned, the strategy would appear to offer a very good prospect of reducing the tax chargeable on the gift by at least half, whilst having no other adverse effects.

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[5] But not necessarily in all cases.