The Personal Tax Planning Review

INHERITANCE TAX "TRAPS" IN CAPITAL GAINS TAX PLANNING SCHEMES

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The Envelope Trick

Readers of this *Review* will know that it is not that difficult to devise a tax planning strategy which is in itself brilliant when viewed in isolation. The real problem often comes in dealing with the side-effects, fiscal and otherwise, of the strategy. In this article I shall discuss some alleged Inheritance Tax side-effects of a capital gains tax avoidance scheme known as "the envelope trick". These side-effects are also of general interest.

The scheme allowed capital gains tax on the sale of substantial holdings in privately held trading companies and certain other assets to be deferred or avoided. The owner would set up an offshore pilot trust, typically one in which he had a life interest in possession, and the trustees would then acquire a £100 UK resident holding company, to which the owner/settlor would then gift the shares. An election for hold-over relief would then be made[1] so as to preclude any charge to capital gains tax on the donor. The trustees would in due course, if they thought fit, sell the shares in the holding company. Any gain they realised would be tax-free in the first instance, although it could be taken into account for the purposes of the Offshore Beneficiary Provisions, formerly contained in FA 1981 ss.80-85 and now to be found in TCGA 1992 ss.87-97.

The envelope trick in its simple form was legislated against as from Budget Day 1989, although variants with greater or lesser degrees of effectiveness are still possible.[2]

Let us assume that the strategy was adopted by a Mr and Mrs H, who were married to each other. Mr H owned 58% of the shares and Mrs H owned 42%

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1 Pursuant to CGTA 1979 s.126.

2 See generally my *Non-Resident Trusts* 5th Edition 11.5A.5. The surviving possibilities have been discussed by myself and others at Key Haven conferences from time to time.

of the shares in the trading company which it was planned to sell. The new holding company is referred to as "Newco".

A Chargeable Transfer?

Alleged Value-Shifting

It is alleged that, in implementing the scheme, Mr and Mrs H made chargeable transfers for inheritance tax purposes. The argument runs that the transfer of the shares by them to Newco would have diminished the value of their respective estates and given rise to an immediate chargeable transfer. It is alleged that this follows from the fact that before entering into the structure they each owned their respective shareholdings outright, while afterwards, for inheritance tax purposes (by virtue of their respective interests in possession) they would have been respectively treated as owning 58% and 42% of Newco, with the result that neither had the ability to wind-up Newco and so gain access to their original shareholdings.

Now this is a problem which no client of mine would ever have had to face. I would in any event have advised that each of them set up a separate trust which in turn owned a 100% holding in its own holding company. The value of a 100% holding in a holding company which has no liabilities and which itself owns merely a 58% (or a 42%) holding in a trading company is the same as a 58% (or 42%) holding in the trading company.

Related Property

The allegation that there would be a diminution in value of the respective estates of the settlors if only one holding company were used for both settlements is in any event misconceived. One must not overlook a most important valuation provision in the Inheritance Tax Act 1984, namely section 161, which is headed "Related property". Section 161 provides:

> "(1) Where the value of any property comprised in a person's estate would be less than the appropriate portion of the value of the aggregate of that and any related property, it shall be the appropriate portion of the value of that aggregate.
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> (2) For the purposes of this section, property is related to the property comprised in a person's estate if-
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> (a) it is comprised in the estate of his spouse ...
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> (3) The appropriate portion of the value of the aggregate mentioned in subsection (1) above is such portion thereof as would be attributable to the value of the first-mentioned property if the value of that aggregate

were equal to the sums of the values of that and any related property, the value of each property being determined as if it did not form part of that aggregate.

(4) For the purposes of subsection (3) above the proportion which the value of a smaller number of shares of any class bears to the value of a greater number shall be taken to be that which the smaller number bears to the greater; and similarly with stock, debentures and units of any other description of property."

Was there in fact any Value-Shifting?

Applying the section to the present case, one valued Mr H's 58% holding in the trading company at 58% of the value of a 100% holding. Similarly, one values the 58% holding in the holding company he would have been deemed to own at 58% of the value of a 100% holding in the holding company. As the value of a 100% holding in the holding company would have been the same as the value of a 100% holding in the trading company, there would have been no diminution in the value of Mr H's estate for inheritance tax purposes as a result of the gift.[3] The same applies to Mrs H's 42% holding.

I do not in any case agree that Mr H's estate (as opposed to Mrs H's estate) would in reality (ignoring the related property rules) have diminished in value. To my mind, a 58% holding in a company which has a 100% holding in a trading company is *more*, not less, valuable than a 58% holding in the trading company. A 58% holding in the holding company gives one the power to control the appointment of the directors of the holding company and the directors of the holding company have greater control over the trading company by being able to exercise the voting power attached to the 100% holding in it of the holding company than does a 58% shareholder in the trading company. In particular, they can secure the passing of a special resolution (which normally requires a 75% vote in favour) and thus alter the articles of the trading company or wind it up. Hence a 58% shareholder in the holding company has, indirectly, greater control of the trading company.

Gratuitous Intent

Persons supporting the allegation sometimes go on to consider a possible solution to what appeared to them to be the problem that the gifts of shares in the trading company to the holding company would have caused a diminution in the estates of Mr and Mrs H. Before examining these views, let us first remind ourselves of some fundamental concepts of inheritance tax.

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[3] I am assuming, as the contrary argument does, that the gifts by each of the spouses would have been contemporaneous.

The tax is *charged* on "the value transferred by a chargeable transfer": Inheritance Tax Act s.1.

A *chargeable transfer* is "a transfer of value which is made by an individual but is not ... an exempt transfer": Inheritance Tax Act s.2(1).

A *transfer of value* is "a disposition made by a person ... as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition; and the amount by which it is less is the value transferred by the transfer": Inheritance Tax Act s.3(1).

As inheritance tax is a tax on gifts, and not on bad bargains, some further provision was needed. This is section 10, the side note to which is "Dispositions not intended to confer gratuitous benefit". Section 10(1) provides:

> "A disposition is not a transfer of value if it is shown that it was not intended, and was not made in a transaction intended, to confer any gratuitous benefit on any person and either
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> (a) that it was made in a transaction at arm's length between persons not connected with each other, or
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> (b) that it was such as might be expected to be made in a transaction at arm's length between persons not connected with each other."

Those making the allegation sometimes state that "the test of intent is an objective one". I cannot agree. An "objective intent" is a contradiction in terms. It is no more an intent than a forged pound note is a pound note.[4] They appear to be saying that wherever someone else will benefit from one's disposition, one must necessarily have a gratuitous intent. Purely for my own delectation, I may pay £2,000 for a firework display. I do not have any intent to confer a gratuitous benefit on any person and the position is not changed if I have neighbours who will also see it and enjoy it. Nor does it make any difference that I know that I have neighbours who will also see it and enjoy it. So too, here, if Mr and Mrs H's motive in gifting shares to the holding company were to benefit themselves, by lawfully avoiding, or at least deferring, a liability to capital gains tax, it is irrelevant that some third party might have derived an indirect benefit.

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4 Of course, whether a person subjectively had a particular intent must be determined as a fact in a court of law by consideration of all lawful evidence, which may often include objective criteria; but that is a very different matter from a so-called "objective intention".

Reservation of Benefit

Detractors of the strategy are also concerned at the possible application of the Inheritance Tax Gifts with Reservation of Benefit provisions. They sometimes fasten on the gift of shares in the trading company to the holding company and argue that, since the settlor was not, by virtue of being a beneficiary under the settlement, excluded from benefiting from the gifted shares, he therefore prima facie reserved a benefit in respect of the gifted shares. Thus, the argument continues, his inheritance tax position would have been substantially worsened if he had died while Newco still owned the gifted shares. For he would both have been treated by s.49(1) as owning the shares in Newco and, under the reservation of benefit provisions, as owning the trading company shares which he had given to Newco. It is alleged that he would thus have artificially increased the value of his estate for inheritance tax purposes.

Let as assume that since the settlor was not excluded from benefiting from the gifted shares, he therefore prima facie reserved a benefit in respect of the gifted shares. While the position is not so simple, I accept that this view is a tenable one.

The view that the settlor's inheritance tax position would have substantially worsened if he had died while Newco still owned the gifted shares clearly presupposes that the trustees of the settlement would, contrary to the scheme, have continued to hold the shares in the holding company. Let us, however, assume that for some reason the trustees did *not* sell their shares and the structure continued in being unaltered until the death of the settlor. Does the conclusion follow? Let us go back, as all competent tax advisers must, to the *ipsissima verba* of Finance Act 1986 s.102(3):

> "If, immediately before the death of the donor, there is any property which, in relation to him, is property subject to a reservation then, to the extent that the property would not, apart from this section, form part of the donor's estate immediately before his death, that property shall be treated for the purposes of the 1984 Act as property to which he was beneficially entitled immediately before his death."

The relevance of the property subject to a reservation being treated as "property to which he was beneficially entitled immediately before his death" is to be found in Inheritance Tax Act 1984 s.4(1):

> "On the death of any person tax shall be charged as if, immediately before his death, he had made a transfer of value and the value transferred by it had been equal to the value of his estate immediately before his death."

Again, the proponents of the contrary view appear to have overlooked the long-established rules relating to the application of deeming provisions in statutes.[5] As Lord Asquith said in *East End Dwellings Co. Ltd v Finsbury Borough Council* [1952] AC 109: "If you are bidden to treat an imaginary state of affairs as real, you must surely, unless you are prohibited from doing so, also imagine as real the consequences and incidents which, if the putative state of affairs had in fact existed, must inevitably have flowed from or accompanied it."

The argument is that you deem the settlor to be beneficially entitled to the shares in the trading company which he had previously gifted; at the same time you deem him to be beneficially entitled to the shares in the holding company in reality owned by the trustees of the settlement. So far, so good. The flaw lies, as it often does in enthymematic reasoning, in the implied premise: "You value the shares in the holding company on the basis that that company owns the shares in the trading company gifted to it." Yet a moment's thought will show this cannot be the case. If, at the relevant time, namely the moment before he dies, the settlor is deemed to be beneficially entitled to the shares in the trading company, it follows by necessary implication that the holding company cannot be beneficially entitled to the same shares. Hence, in valuing the shares in the holding company the settlor is deemed to own at that time, one proceeds on the fiction that it does not own the shares in the trading company which it in fact owns. There is thus no possibility of a double charge to inheritance tax.

Loans to the Settlor

Some persons have "identified" what they believes to be an "IHT Loanback Problem"[6]. In their view, Finance Act 1986 s.103 would prevent the deductibility of the amounts owed by the settlor to the trustees in computing the value of his estate for inheritance tax purposes on his death. They therefore conclude that the making of an interest-free loan to the settlor of, say, £10,000 would thus have carried with it a potential price tag of, say, £4,000 in IHT.

This is a point of widespread importance, particularly in the case of non-UK resident trusts where loans to beneficiaries, particularly to the tenant for life, are routinely used as a means of avoiding or mitigating a liability to capital gains tax

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5 The rules were reiterated by the Court of Appeal in *Marshall v Kerr* in March 1993, reported shortly thereafter in [1993] STC. At the hearing before the Appellate Committee of the House of Lords of the appeal by the Revenue against that decision on 13th and 14th December, it was accepted by the Revenue that the Court of Appeal decision correctly set out the relevant law. The Committee has not, as at 23rd May, indicated when it will report.

6 Their jargon, not mine.

under the Offshore Beneficiary Provisions or to income tax under TA 1988 s.740 (tax avoidance - transfers of assets abroad - non-transferors).

Let us go back once more to the *ipsissima verba* of Finance Act 1986. Section 103(1) provides:

> "... if, in determining the value of a person's estate immediately before his death, account would be taken, apart from this subsection, of a liability consisting of a debt incurred by him or an incumbrance created by a disposition made by him, that liability shall be subject to abatement to an extent proportionate to the value of any of the consideration given for the debt or incumbrance which consisted of-
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> (a) property derived from the deceased ..."

I agree that if the trusts of the settlement had been, say, discretionary, then there might be a real problem here. Even in such case, however, provided the debt owed to the trustees were secured, they would be entitled to be repaid that debt in priority to any claim by the Revenue. The Revenue could look only to the personal representatives of the settlor for the inheritance tax on what was in reality a non-existent part of his estate. The personal representatives would be liable to pay the tax only to the extent of the real net assets of the estate. Hence, provided matters were properly structured, there would be no funds left in the estate to pay the inheritance tax, so that the tax charge would be theoretical. For the charge would bite only if and to the extent that there were in reality net assets in the estate. Yet if the settlor is having to borrow from the trustees, it is unlikely that there would be such net assets.

Where the settlor had during his life an interest in possession in the settled property, which would have been the case if Mr and Mrs H had followed my advice, the position is in any case entirely different. By virtue of Inheritance Tax Act s.49(1), a person beneficially entitled to an interest in possession in settled property is to be treated for the purposes of the Inheritance Tax legislation as beneficially entitled to the property in which the interest subsists. If one applies Lord Asquith's dictum, what is deemed to happen when the settlor in fact borrows money from the trustees? As he is deemed to own the money before it is borrowed, he cannot borrow it from himself. The transfer of the money to himself is a non-event for Inheritance Tax purposes. His estate is subject to no debt, as a man cannot owe a debt to himself. The question of any such debt being treated as non-deductible in computing the value of his estate for inheritance tax purposes therefore does not arise. Conversely, however, the settled property does not include the right to sue the settlor for the money borrowed, as a man cannot have a right against himself. The effect of the deeming provision is entirely sensible, in that precisely the right amount is brought into charge to tax on the death of the settlor. If, for example, the trust fund is worth £1,000,000 and the settlor/tenant for life borrows £200,000 and then dies, the trust fund is deemed to be worth only £800,000 as the right to be repaid the £200,000 falls to be ignored. The settlor's free estate has been increased by £200,000 as he has received £200,000 in cash and the liability to repay it falls to be ignored. If the settlor has frittered away the £200,000 in the meantime, with nothing to show for it, then his total estate, actual and deemed, for inheritance tax purposes will indeed have been reduced by £200,000; but that would equally have been the case if he had simply consumed £200,000 of his free estate without any borrowing.

Conclusion

Whether my views are correct or not, the moral is that, in devising a tax planning strategy for one tax, one must always keep other taxes in mind.