The Personal Tax Planning Review

GIFTS WITH RESERVATION - TWO PROBLEM AREAS - PART II

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Life Tenants and Reserved Benefits

The factual situation envisaged is this:

X is entitled to an interest in possession under a settlement. The settled property includes Blackacre. X's interest in possession comes to an end in his lifetime. Blackacre becomes the property of the remainderman entitled in expectancy on the determination of X's interest. X, either then or subsequently, continues to enjoy Blackacre rent free.

Is Blackacre caught by the reservation of benefit rules in s.102 FA 1986 on X's subsequent death? For the purposes of convenience, reference to "the life tenant" will include X whether his interest was limited by reference to a life or not.

X is to be treated as if he had made a transfer of value and as if the value transferred were equal (subject to any available business or agricultural property relief) to the value of the property in which his interest in possession determined (s.52 IHTA 1984). The "deeming" effect of s.52 is of importance, for X is not otherwise to be treated as making a transfer of value. In particular he will not be treated as if he had made a transfer attributable to the value of his interest in possession (s.51 IHTA). But reference to these provisions does not provide any real assistance in answering the question posed.

Under the Estate duty regime the answer was simple. A number of provisions (starting with s.11 FA 1900, and most notably s.43 FA 1940) would have had effect so as to cause Blackacre to be included in the property "passing" on the death of X for the purposes of Estate duty in all but exceptional cases. The draftsman of the 1986 Act has not seen fit to include or adapt the Estate duty provisions. So the taxpayer and the Revenue are left to make what they can of s.102 and the provisions of Sched 20 FA 1986.

Anyone required to answer the question raised above will first respond by seeking further information as to the settlement and the circumstances in which X's interest in possession came to an end: (1) Who was the "settlor" (defined as for the

purposes of s.44 IHTA 1984 to include persons providing property for the purpose of the settlement)? In particular was X a settlor? (2) To whom did the property - specifically Blackacre - revert on the termination of X's interest in possession? (3) Did X's interest terminate either (a) under the trusts of the settlement, or (b) as the result of an exercise by the trustees of a power in the settlement, or (c) as a consequence of an actuarial partition of the settled property or other agreed variation, or (d) as the result of a voluntary surrender or assignment by X? There are two other questions not arising out of the factual situation considered above: (4) Did the interest continue to subsist or did it cease to exist and merge in some other interest? (5) One further question will also be pertinent in all cases where X was not merely the life tenant but also the settlor; that is, did Blackacre cease to be settled property as a consequence of the termination of the interest?

Settlor Entitled to Interest in Possession

The significance of the identity of the settlor is that acts done under or by virtue of powers or trusts in the settlement may be regarded as written into the gift in settlement. X's status as the donor for the purpose of the "reservation of benefit" rules is due solely to his status as the settlor. The fact that he may also be regarded as a donor in relation to the termination of his interest in possession (given up by surrender or assignment) does not mean that the event occasioning the termination of his interest in possession operates by way of a fresh gift.

If X was the settlor a gift on trusts which conferred a life interest in possession on X would not normally be regarded as a gift with reservation. X's interest in possession which would otherwise qualify as a benefit reserved is not the subject matter of the gift. The subject matter of the gift is the reversion expectant on determination of X's life interest and he has not reserved a benefit out of that.[2] Whilst the settlement subsists, therefore, there is no reservation of benefit. But that does not mean that s.102 is of no further relevance.

If the settlement comes to an end as respects Blackacre (in the example) before X's death and X thereafter regains possession and enjoyment of the property, para 5(2) of Sched 20 deems Blackacre to be the property comprised in the original gift and accordingly it will be caught by the reservation of benefit provisions. The same result would follow if the settlement continued after termination of X's interest in

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[2] This will not be so in every case. X (the settlor) may have reserved a benefit as the object of a discretionary power of appointment. If the power is subsequently exercised by appointing an interest in possession to X, the settled property appointed would continue to form part of X's "estate" under ss.5 and 49 IHTA. In such a case the settled property escapes the double charge on X's death by virtue of s.102(3) FA 1986.

possession and X thereafter continued to enjoy a benefit out of or the possession and enjoyment of Blackacre (or any substituted property) which remained comprised in the settlement.

However, para 5(2) of Sched 20 makes no provision for cases where property ceasing to be settled property prior to the settlor's death has thereafter been sold or disposed of and some other property (out of which the donor/settlor reserves a benefit) substituted therefor. In particular, the provisions of para 2 of Sched 20 which make limited provision for the substitution of property acquired on sale or exchange of the originally gifted property have no application. The property comprised in the gift out of which a benefit is to be reserved is thus limited to the property in its state of investment when it leaves the settlement. If, therefore, in the example described above, Blackacre was to be sold or exchanged and X as the former life tenant (and settlor) was to enjoy a benefit out of some substituted property, the reservation of benefit rules could not bite on the substituted property.

Persons Entitled on Termination - Spouses and Charities

On the view taken below under the sub-heading "Surrender of Interests in Possession" the character of the persons taking the property in which the life tenant had an interest in possession which has been determined is irrelevant. If, however, contrary to the view expressed below, the property comprised in the gift of an interest in possession effected by surrender or assignment is treated as the underlying property comprised in the settlement, the nature of the persons taking the property out of which a benefit is reserved by the former life tenant will become significant.

Subsection (5) of s.102 FA 1986 provides:

> "This section does not apply if or, as the case may be, to the extent that the disposal of the property by way of gift is an exempt transfer by virtue of the following provisions of Part II of the 1984 Act, "(*inter alia*)
>
> (a) section 18 (transfers between spouses)
>
> (b) section 23 (gifts to charities)

Now the event which causes a person to be treated as if he had made a transfer of value, such as the termination of an interest in possession, is to be treated for the purpose of the provisions of s.18 and s.23 IHTA as if it was itself a transfer of value (see s.3(4) IHTA). The termination of X's interest in possession in circumstances which resulted in Blackacre becoming the property of X's spouse

or a charity would accordingly be the subject of an exempt transfer of value. If, therefore, the life tenant's interest in possession is determined by surrender or assignment by way of gift and (contrary to the view expressed below) that gift is to be treated as a gift of the underlying assets comprised in the settlement, s.102 will not apply in respect of any benefit reserved to the life tenant out of property which passes into the ownership of the life tenant's spouse or a charity.

In practice it is unlikely that a donor could enjoy a benefit out of property gifted to charity (or property to which a charity became entitled on the termination of an interest in possession) without the commission of a breach of trust by the trustees of the charity.

None of the above will apply if the life tenant was the settlor. Although the transfer of value deemed to take place when his interest determines is an exempt transfer, the gift of property out of which the benefit was reserved was the original gift in settlement. The position in respect of benefits reserved out of property taken by the settlor/life tenant's spouse will be that described above under the sub-heading "Settlor Entitled to Interest in Possession". S.102(5) will provide no escape for the benefits reserved in such cases.

Termination of Interests in Possession Under Trusts of the Settlement or as a Consequence of Exercise of a Power of Appointment

Here again, a distinction should be drawn between cases in which the person entitled to the interest in possession was the settlor and those in which he was not the settlor. An appointment in exercise of a special power which operates to determine an interest in possession is no more than the filling out of trusts left undeclared by the original settlor. Such appointments are read back into the settlement so as to form part of the same. Such an appointment will therefore be treated as if it was part of the terms on which the original disposal by way of gift was made. If, therefore, X in the example cited was the "settlor" as defined by s.44 IHTA, a benefit reserved out of the settled property appointed so as to cause X's interest in possession to determine would be treated as the reservation of a benefit out of property originally the subject of the gift in settlement, and the position will be as described above under the sub-heading "Settlor Entitled to Interest in Possession".

Where the person entitled to the interest in possession is not the "settlor" there is no way in which the property in which his interest determines as a consequence either of the operation of the trusts of the settlement or of the exercise of a power reserved in the settlement can be brought within the reservation of benefit net cast by the provisions of s.102. It suffices to observe that the person entitled to the interest in possession will not in that event have made a "gift". His interest will

have been defeated or determined, not as a consequence of any gift by him, but as a consequence of the terms of the settlement or of the exercise of the dispositive power by the trustees. It is unnecessary to consider whether in such cases there has been a "disposal" of "property" for the purposes of s.102.

Termination of Interests in Possession as a Consequence of Exercise of a Power of Appointment with Consent of Life Tenant

The view expressed in the preceding paragraph needs to be qualified where the interest in possession can only be determined by the trustees with the approval of the life tenant. Typical of such cases is an exercise by the trustees of the statutory power of advancement found in s.32 Trustee Act 1925. Some settlements do, of course, modify s.32 (where it applies) by excluding the need to obtain such consent and it is unusual to find such consent made requisite to an express power of advancement or appointment contained in a settlement. But in most cases in which the statutory power of advancement is exercisable such consent remains requisite.

Does the giving of such consent involve the disposal by the life tenant of any property by way of gift? If the answer to the question posed below under the sub-heading "Surrender of Interests in Possession" is in the negative, it may not matter whether it does or not. But if one is obliged to treat the subject matter of any disposal or deemed disposal of his interest in possession by a life tenant by way of gift as the underlying settled property, the answer to the question here posed clearly becomes relevant.

There is a division of professional opinion as to the answer to be given. A life tenant giving consent to the exercise of the statutory power in favour of the trustees of a settlement may, as a consequence of that consent, be said to be providing property for the purposes of such other settlement and accordingly be a "settlor" for the purposes of such other settlement; and accordingly be a "settlor" for the purposes of such provisions as s.681 Income and Corporation Taxes Act 1988 (see *Buchanan v IRC* (1958) 37 TC 365). But in my view a "disposal of property by way of gift" involves something more than a mere acquiescence or consent to the disposal of property by another (the trustees) - even if the legitimacy of that act of disposal is made to depend on such acquiescence or consent. Accordingly, a benefit reserved to the life tenant out of property advanced or appointed with his consent will not be caught by s.102.

Partition

The partition here is assumed to be a partition on an actuarial basis between the life tenant or other person entitled to the interest in possession and those entitled to other interests in the settlement; the situation envisaged is one in which X (the life tenant) reserves a benefit out of property taken by the other parties as a consequence of the partition.

Partitions on an actuarial basis will not usually involve any act of bounty either on the part of the life tenant or on the part of the remainderman. It is hard to see how s.102 would in such cases operate to bite on the property taken by the other parties out of which the benefit has been reserved. For s.102 to bite there must be a "gift" of property and where there is no bounty there is no gift.

There is no authority which would suggest that a contrary view is likely to be taken. In *Berry v Warnett* [1982] STC 396 an attempt was made to persuade the House of Lords that a sale for full market value (as part of a scheme for avoiding tax) of an equitable reversionary interest carved out of shares coupled with a disposal of the shares to settlement trustees was a "gift" into settlement for the purpose of what is now s.70 Taxation of Chargeable Gains Act 1992. It failed. The House of Lords decided that there was no "gift" but that the taxpayer had disposed of the property becoming comprised in the settlement on general principles. It was unnecessary for the Revenue to rely on the gift into settlement provisions of s.70. Given the focus of inheritance tax on gratuitous transfers and the specific exclusion from the definition of a transfer of value of reductions in the value of a person's property resulting from arm's length bargains (s.10 IHTA), I can see no different result if the courts were called on to construe the word "gift" in s.102 FA 1986.

A partition on the basis outlined above will usually result in a charge - or potential charge - to inheritance tax under s.52 IHTA - the value transferred for such purposes being measured by reference to the value of the property taken by the other parties to the partition (s.52(2) IHTA). But I see no ground for equating the making of a "gift" with the making of a transfer of value, *a fortiori* a provision such as s.52(1) which provides merely that tax shall be charged as if the person entitled to the interest in possession which determines had made a transfer of value.

It follows that in the generality of cases s.102 will not operate to catch property taken by other parties to the partition out of which the life tenant or other party giving up his interest reserves a benefit.

Variation of Trusts

Are there exceptions to this? One obvious exception is where the life tenant agreeing to the partition is himself the settlor. This is considered above under the sub-heading "Settlor Entitled to Interest in Possession". But this is an exception not because the partition involves a gift, but because the reservation of benefit provisions refer back to the original gift made when the settlement was made.

The provisions may (on the assumption that the views expressed below in relation to surrenders of interests in possession are wrong) bite in cases where the property out of which the benefit is reserved is taken on a partition made pursuant to an arrangement approved by the Court under the Variation of Trusts Act 1958. The Court will not give its approval to an arrangement unless those seeking its approval can point to some tangible benefit which the infants and unborns on whose behalf the Court's approval is given will gain from the arrangement. Such benefit will often involve the setting aside of some part of the settled property by way of insurance premiums or otherwise which would itself reduce the value of the property which the adult beneficiaries might expect to receive if the approval of the court to a partition was not required. In *Thorn v IRC* [1976] STC 208 it was decided that such arrangements should be stamped as voluntary dispositions *inter vivos* for the purposes of the provisions (now repealed) in s.74 F (1909-10) A 1910. The decision proceeded on the basis that it involved an element of gift. Although *Thorn* did not involve a partition, but rather the giving up of a protected life interest and a reversionary life interest for an immediate prospect of benefit under a discretionary trust, my view is that a similar principle could be applied on any partition which resulted in the adult beneficiaries receiving less than they would if the approval of the Court was not required. But even in such cases the reservation of benefit rules should not bite on property taken by others out of which the life tenant reserves a benefit (see sub-heading "Surrender of Interests in Possession").

Surrenders of Interests in Possession

The situation envisaged here is one in which X (the life tenant) surrenders or assigns his interest in Blackacre to the remaindermen who thereafter permit X to remain in Blackacre rent free. The surrender will plainly involve a gift by X and accordingly the contentions set out above (relating to appointments and relating to partitions) are not available. But the observations here made are equally applicable where the life tenant receives less on a partition than the actuarial value of his share.

The effect of the surrender (as with the appointments and partitions considered above) is to bring the interest in possession in the property to an end. One

possible argument is that such a surrender does not involve a disposal or disposition of any property by the life tenant X. For there to be a disposal of property, the property must exist after the act of disposition; if the act relied on operates to destroy the subject matter (the property), that is not a disposition. Support for this contention might be found in s.45(2) FA 1940 which provided (for Estate duty purposes) that "the extinguishment at the expense of the deceased of a debt or other right shall be deemed ... to have been a disposition made by the deceased for whose benefit the debt or right was extinguished and in relation to such a disposition the expression "property" in the said enactments shall include the benefit conferred by the extinguishment ..." Why, it might be enquired, should such provision be necessary if releases or surrenders which operated to destroy the right released or surrendered were otherwise caught by the Estate duty legislation relating to gifts of property - including gifts out of which a benefit was reserved?

In my view these arguments are not well founded. I leave out of consideration for the present the existence of the separate Estate duty rules relating to the termination of interests in possession (see further below). It is clear that it was intended that "dispose" and "disposition" have an altogether wider meaning for the purposes of inheritance tax than they had for the purposes of Estate duty. If these words had a narrow meaning it would have been unnecessary to except waivers of remuneration and waivers of dividends (which plainly involve the extinguishment of a right) from the definition of transfers of value (ss.14 and 15 IHTA). The express inclusion of "omissions" to exercise rights as transfers of value (s.3(3) IHTA) makes little sense if there is left an intermediate class of waivers or surrenders which, because the right released is destroyed, involve no "disposition" for inheritance tax purposes.

But the argument used to sustain the view that an extinguishment of an asset involves no "disposition" of the asset (viz, that the asset has ceased to exist) is not irrelevant. A life tenant who surrenders his interest is disposing of his interest in possession which will merge in the remainder and be extinguished. As an item of property it will have ceased to exist. It is that property which is the subject of the disposal by way of gift. If the life tenant thereafter enjoys a benefit provided out of property which was originally subject to his life interest it can hardly be said that that amounted to the reservation of a benefit out of the property (viz, the interest in possession) which had then ceased to exist. What contentions can be advanced to support the view that the reservation of benefit rules bite in such a case?

One view is put thus: the surrender is a disposition by way of gift. So much is common ground. By virtue of s.49(1) IHTA the life tenant is to be treated as if he was beneficially entitled to the property in which his interest in possession subsisted. Accordingly, a gift of the life interest by way of surrender is to be

treated as effectively involving a gift of the underlying property comprised in the settlement. So in determining whether a benefit has been reserved one is entitled to consider whether the life tenant has reserved a measure of enjoyment of the underlying property in which his interest had subsisted.

This approach has the advantage of simplicity and accords with what might be assumed to be the legislative intent in engrafting Estate duty concepts into the scheme of inheritance tax. In my view, however, the language of the Inheritance Tax Acts will not bear such an interpretation. The interpretation confuses the settled property (which is not the subject of the gift) with the interest in possession under the settlement (which is the subject of the gift). Para 6(2) Sched 20 FA 1986 requires one to determine the question of whether a benefit is reserved out of any gifted property by reference to the property which is at the relevant time treated as property comprised in the gift. The life tenant may be deemed to be beneficially entitled to the underlying assets by reference to which his transfer of value is calculated. But to say that he shall be treated as making a transfer of value equal to the value of the settled property (s.52 IHTA) is very far from providing that he shall be treated as making a gift of the same. The property comprised in the gift is the interest in possession. On their ordinary meaning the words in s.102 FA 1986 "disposes of any property by way of gift" are simply not capable of including the underlying property comprised in the settlement over which the life tenant will have no power of disposition.

Of course, the settled property in which the interest subsisted forms part of the inheritance tax "estate" of the life tenant (per ss.5 and 49 IHTA). It will have ceased to form part of his "estate" as a consequence of the surrender. But it does not follow that there is a licence to include an addendum to the words in s.102 "disposes of any property by way of gift" of words needed to give effect to what some might perceive to be the legislative intent; viz, "or disposes of a beneficial interest in possession in any property by way of gift".

One alternative is to rely on the provisions of para 2 of Sched 20 FA 1986 which deem property received by the donee in substitution for the gifted property to be property comprised in the gift. In my view para 2 provides no assistance. Where a life interest is surrendered it will on surrender merge with the interests in remainder. It will cease to exist. The remaindermen will never receive the interest as an item of property. It is therefore misleading to treat the assets of the settlement which will vest in the remaindermen by virtue of their own beneficial interests and the surrender as if they were "property comprised in the gift".

Support for the preferred view can be found in the history of the Estate duty antecedents and of the PET regime introduced in 1986.

By s.2(1)(b) FA 1894 (in its original form) property in which a person had an interest limited to cease on death was deemed to "pass" on the death of the deceased. There was nothing to forestall arrangements for avoiding the charge on the property so "passing" by procuring that the life interest in possession should be determined by surrender or otherwise prior to the death. An attack on a surrender of a life interest within 12 months of death under s.2(1)(c) failed in *A-G v De Préville* [1900] 1 QB 223.

Now, although property in which the deceased had what is now called an "interest in possession" was included in the property "passing" on his death, there was no suggestion that the reservation of benefit rules which originally applied only to absolute gifts of property were capable of application to gifts of property otherwise dutiable under s.2(1)(b) FA 1894 in its original form. Section 11 of the Customs and Inland Revenue Act 1889 contained the provisions which caught *inter vivos* gifts of property out of which the deceased donor had reserved a benefit. Property passing for the purposes of Estate duty on death of a donor included:

> "property taken under any gift, whenever made, of which *bona fide* possession and enjoyment shall not have been assumed by the donee immediately upon the gift and thenceforward retained, to the entire exclusion of the donor, and of any benefit to him by contract or otherwise."

If the reservation of benefit rules in s.102 FA 1986 had been intended to bite on property in which an interest in possession has ceased it would have been equally intended that s.11 Customs and Inland Revenue Act 1889, which makes use of not dissimilar wording and is intended to have like effect to s.102, would have been treated as applying to erstwhile settled property which would have passed on the death of a person reserving a benefit in such property but for the cesser of his interest in possession in such property before his death. Yet Parliament has by the enactment and re-enactment of provisions providing expressly for cases where benefits are reserved out of property in which the deceased had had an interest in possession consistently shown that little or nothing was thought of this line of attacking reservations of benefits out of property originally comprised in settlement.

So, by s.11 FA 1900 reservation of benefit rules similar to those applicable to absolute gifts *inter vivos* were expressly applied to reservations of benefits out of property in which the deceased had an interest limited to cease on death but which had been "surrendered, assured, divested or disposed of" before the death. Where the deceased was wholly excluded from benefit, the settled property escaped the charge as property passing, provided the surrender, etc., was more than 12 months prior to the death.

The measure thus introduced by s.11 FA 1900 was repeated with modifications (mainly relating to the period between surrender, etc., and death) in s.43 FA 1940 and in the modified s.2(1)(b)(ii) FA 1894 introduced by s.36 FA 1969.

An explanation as to why the parliamentary draftsman did not see fit to modify or adapt the Estate duty enactments described in the preceding paragraphs for the purposes of s.102 FA 1986 is apparent from the short history of s.102 itself. This was introduced in haste to supplement the PET provisions found in the new s.3A IHTA which were themselves brought in by para 1 Sched 19 FA 1986. The object was to prevent taxpayers taking advantage of the new PET relief by continuing effectively to enjoy the gifted property as if they continued to own the same. Donors were not to have their cake and eat it. As originally enacted in 1986 the new PET rules applied only to transfers of value made by an individual, and occasions on which tax was to be charged as if a transfer of value had been made were specifically excluded. So in 1986 it was assumed that surrenders or other acts as a consequence of which an interest in possession determined in the lifetime of the person entitled thereto would not qualify as PETs. The supplementary rules in Sched 20 were enacted on this assumption. In the following year s.96 F(No. 2)A 1987 extended the PET relief to life-time terminations of interests in possession (provided other conditions were satisfied). But no steps were then taken to supplement s.102 or Sched 20 FA 1986 by the introduction of provisions on the lines of s.11 FA 1900 or s.43 FA 1940.

If the above view is correct, s.102 FA 1986 does not apply to benefits reserved out of property in which the person reserving the benefits (not being the settlor) was formerly entitled to an interest in possession. This is so whether the interest comes to an end as a consequence of the exercise of a power by the trustees (with or without the consent of the life tenant), by operation of the trusts of the settlement, as a consequence of some variation of the trusts or a partition of the funds or as a consequence of the gratuitous surrender or assignment by the life tenant of his interest in the settlement.

Termination of Interest in Possession - Property Remaining Settled

Does it make a difference if, following the gratuitous assignment of an interest in possession, the interest assigned continued to subsist, i.e., as an interest *pur autre vie*? The benefit is not in such cases reserved immediately out of the gifted interest in possession. But it would be impossible to claim that the gifted interest was enjoyed to the entire exclusion of the donor in a case where the donor reserved a benefit in the underlying property. The editors of *Foster's Capital Taxes* at para 4.44 express some reservations as to whether the charge can then attach to the underlying property or merely to the actuarial value of the interest. But given the fact that the subject matter of the gift is the interest in possession,

and not the underlying property, the answer to the question posed should be "no" so far as the property sought to be attacked under the reservation of benefit rules is the underlying property in which the interest subsisted.

If a benefit is reserved out of the underlying property, will a charge under s.102 FA 1986 attach to the actuarial value of the interest itself? At first blush this is an unattractive proposition. Property held for the life of another but on terms under which no individual has an interest in possession is (subject to exceptions) relevant property subject to the regime and charges found in ss.58 to 85 IHTA applicable to what might loosely be called discretionary settlements. If another person is beneficially entitled to the interest, the settled property may well be the subject of a charge on that person's death, so there is a possibility of a double charge. The scheme of inheritance tax as it applies to interests in possession operates in a way calculated to ensure that tax will never be charged on the termination of that interest by reference to the value of the interest in possession (s.51 IHTA).

Nonetheless, my view is that a reservation of benefit out of the underlying property in which the interest in possession formerly subsisted will amount to the reservation of a benefit out of the gifted property itself (i.e, the interest assigned). An interest in possession, like any other item of property, may have a value and so form part of the "estate" of the person entitled to the same. The provisions of s.51 IHTA which prevent the life-time disposal of an interest in possession from occasioning a transfer of value is a clear recognition of this. So the Revenue would in my view be fully entitled to invoke the charges in s.103(3) and (4) FA 1986 on the actuarial value (if any) of the interest assigned. In practice the charge is likely to be theoretical rather than real in the event of a charge imposed on death (s.102(3)) since in most such cases the interest assigned will be an interest determinable on the death of the donor. But if the benefit determines in the life-time of the donor a charge on the actuarial value of the interest remains a real possibility.