EXCLUDED PROPERTY TRUSTS AND GROBS

Robert Venables QC[1]

1 The Problem

1.1 The Strategy

Before the 1986 Budget Speech, persons who risked becoming domiciled for inheritance tax purposes in the UK would often create an "excluded property" settlement. They would remain beneficiaries under the settlement. The settled property would thus remain outside the charge to inheritance tax notwithstanding the later acquisition of a UK domicile by the settlor.

1.2 The Effect of the Gifts with Reservation of Benefit Provisions

The effect of the gifts with reservation of benefit provisions on such a strategy is highly controversial. Let it be supposed that the settlor creates an excluded property settlement which is in a traditional wide discretionary form. He is an object of the trustees' discretion as to both capital and income. In those circumstances the Revenue will allege, correctly or not,[2] that he has made a gift with a reservation of benefit. On the assumption that the reservation of benefit continues during his lifetime, he will be deemed to be beneficially entitled to the settled property on his death. See Finance Act 1986, section 102(3), which provides: "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".

---

1 Chairman of the Revenue Bar Association, Bencher of the Middle Temple, Fellow and Council Member of the Chartered Institute of Taxation, Chartered Tax Adviser, TEP, Consulting Editor of The Offshore and International Taxation Review, The Personal Tax Planning Review, The Corporate Tax Review and The EC Tax Journal, Taxation Editor of The Charities Law and Practice Review. Chambers: 24, Old Buildings, Lincoln's Inn, London WC2A 3UP. Tel: + 44 (0) 20 7242 2744 Fax: + 44 (0) 20 7831 8095. E-mail: taxchambers@compuserve.com

2 Relying on *Attorney General v Heywood* (1887) 19 QBD 326, *Attorney General v Farrell* [1931] 1 KB 81, *Gartside v IRC* [1968] AC 553 and *Re Weir's Settlement Trusts* [1971] Ch 145. This view was accepted by Lightman J in *IRC v Eversden* [2002] STC 1109.

1.3 The Importance of Excluded Property

The settled property will only form part of his estate immediately before death for inheritance tax purposes. However, if it is not excluded property, see Inheritance Tax Act 1984, section 5(1).

There are two sets of rules for determining whether property is excluded property. One set, contained in Inheritance Tax Act, section 6, applies generally. The other set, contained in Inheritance Tax Act, section 48, applies in the case of settled property. One view is that in determining whether property which is deemed to be included in a person's estate by virtue of Finance Act 1986, section 102(3) is excluded property, it is irrelevant whether the property subject to a reservation is in fact settled property so that one simply applies the general rules. I shall call this the "non-settled property solution". A contrary view is held by many, which I shall call the "settled property solution". As the settled property solution is beneficial to immigrants to the United Kingdom, it is not surprising that it has not been challenged. On the other hand, if the settled property solution is correct, it would work to the disadvantage of the taxpayer in the converse case where a person settles property while United Kingdom domiciled and dies neither domiciled, nor deemed for inheritance tax purposes to be domiciled, in the United Kingdom.

The Capital Taxes Office formerly favoured the settled property solution. In recent years, it is uncertain quite what its position is.

2 The Settled Property Solution

The settled property solution is that where property which is deemed to be comprised in the estate of a deceased person by virtue of Finance Act 1986, section 102(3) is in fact settled property. Then, in determining whether it is excluded property, one applies the rules applicable to settled property, contained in Inheritance Tax Act 1984, section 48, rather than those applicable to non-settled property, contained in Inheritance Tax Act 1984, section 6.

At first glance, this view appears to be wrong. The deceased is deemed, contrary to the facts, to have been beneficially entitled to the property comprised in the settlement. "Beneficially entitled" must mean "beneficially and absolutely entitled". If a person is absolutely entitled to property, then by necessary implication it cannot be settled property: Inheritance Tax Act 1984, section 43. The rules relating to the characterisation of settled property as excluded property and contained in Inheritance Tax Act 1984, section 48 cannot therefore be in point. Instead, one falls back on Inheritance Tax Act 1984, section 6 with the result that the domicile status of the settlor at the time the settlement is created is irrelevant and one is simply concerned with his domicile or deemed domicile immediately before his death.

3 The Policy

The policy behind section 102 is quite clear. A lifetime gift should no longer be effective to secure the advantageous lower rates of tax if it is made with a reservation of benefit. Tax is to be charged on the donor's death as though he had never made the gift.

Given that policy, one would expect it to be quite irrelevant in whom the gifted property was actually vested at the time of the donor's death.[3]

Everyone seems to agree that if the property subject to the reservation is not settled property at the time of the donor's death, then the identity of its actual owner is absolutely irrelevant in determining whether it is to be included in the donor's estate on his death. For example, if I gift a house in Florida to my son who is domiciled in Florida but continue to enjoy a reservation of benefit in respect of it until my death, it is clearly irrelevant that in his hands it is excluded property because it is property situate outside the UK and in the beneficial ownership of a person domiciled outside the UK within the meaning of Inheritance Tax Act 1984, section 6(1).

The argument for the non-settled property solution is that it cannot make any difference that the property subject to the reservation is in reality vested at law in the trustees of the settlement and in equity in the beneficiaries under the settlement. In both cases, the property is deemed to be in the beneficial ownership of the deceased immediately before his death. That is quite inconsistent with its being in the beneficial ownership of any other person or with its being settled property. Moreover, the policy behind the provision is as clearly applicable to a settled gift as to an absolute gift. The donor is to be taxed in either case as though he had made no gift.

4 The Argument for the Settled Property Solution Based on IHTA, Section 49(1)

4.1 The Pro-Argument

There is a good argument in favour of the settled property solution. Inheritance Tax Act 1984, section 49(1) provides that a person beneficially entitled to an interest in possession in settled property is to be treated for the purposes of the Act as beneficially entitled to the property in which the interest subsists. It is generally accepted that this provision is not to be interpreted as requiring one to deem the settled property not to be settled property at all. Thus, in determining whether what is included in his estate is excluded property, one has regard to the test for settled property laid down in section 48 and not that for non-settled property laid down in section 6. The wording of section 102(3) is very similar and thus one should construe the section in the same way.

4.2 The Counter-Argument

One should never forget that there is nothing so Protean as a word or an expression used in a statute. Construction of a statutory provision can properly be undertaken only in its context and by keeping the mischief canon of interpretation to the forefront of one's mind. The very same words can bear entirely different meanings in different

3 Of course, the identity of the original donee may be relevant in determining whether the section comes into play at all; for the section 102(5) exemption may be available. That, however, is quite a different matter.

contexts. That is why legal dictionaries are no substitute for Counsel's Opinion.

Deeming a person to be beneficially entitled to property does indeed entail deeming that property not to be settled property, in the ordinary and natural meaning of the words. Where one finds a deeming provision, one must deem all the necessary consequences unless that leads to injustice or absurdity or would defeat the manifest purpose of the statute. See *Marshall v Kerr* in the Court of Appeal,[4] approved on this point by the House of Lords.[5] If the construction of section 49(1) generally adopted is correct, then there must be some special reason for construing those words otherwise than according to their ordinary and natural meaning. Such reasoning may be totally inappropriate in the context of section 102(3) of the Finance Act 1986. It can be argued that it is abundantly clear from other provisions of the Inheritance Tax Act 1984 that the deeming provision contained in section 49(1) is by no means to apply for all purposes. Moreover, if it did apply for determining whether property which was in fact settled property was to be included in a person's estate immediately before his death, then this would give rise to anomaly.

It should be noted that both section 48 (definition of excluded property in relation to settled property) and section 49 (treatment of interest in possession) are both contained in Inheritance Tax Act 1984, Part III which deals only with settled property. Section 49(1) is a provision which in terms deals only with settled property. By contrast, Finance Act 1986, section 102 deals in principle with all types of property, settled or non-settled.

The following are illustrations of Inheritance Tax Act 1984 provisions where, notwithstanding section 49(1), the beneficiary is treated as being entitled merely to an interest in possession in settled property and not to the settled property itself:

Section 51(1)(2) (disposal of interest in possession)
Section 52(1),(2),(3) and (4) (charge on termination of interest in possession)
Section 53(2),(3) and (4) (exceptions from charge under section 52)
Section 55 (reversionary interest acquired by beneficiary)
Section 56(3) (exclusion of certain exemptions)
Section 71(1) and (4) (accumulation and maintenance trusts)
Section 80 (initial interest of settlor or spouse)
Section 81 (property moving between settlements)
Section 86(4) (trusts for benefit of employees)
Section 99(2) (apportionment of transfer of value made by close company)
Section 101 (companies' interests in settled property)
Section 200 (liability for tax exigible on death by reference to settled property)
Section 201(1)(b) (liability of person entitled for interest in possession in settled property)
Section 269(3) (control of company from settled shares).

Each and every one of these provisions proceeds on the assumption, or only makes

---

4 [1993] STC 360.

5 [1994] STC 638.

sense on the basis, that the deeming provision in section 49(1) is not to apply. These are quite distinct from provisions such as, for example, Inheritance Tax Act 1984, section 142(5) which *expressly* provides that section 49(1) is not to apply for the purpose of section 142 (alteration of dispositions taking effect on death). A more interesting example still is to be found in Part III of Chapter III, which in general exposes settlements without an interest in possession to periodic and exit charges. Section 58(1) defines "relevant property" to mean "settled property in which no qualifying interest in possession subsists". Clearly, it presupposes that section 49(1) does not apply; for if it did, no property in which an interest in possession subsisted, whether a qualifying one or otherwise, would be settled property.

The provision which is perhaps nearest to the present case is section 54(2), which refers expressly to the occasion of the death of a person entitled to an interest in possession in settled property.

Given this multitude of derogations from the operation of section 49(1), it is not altogether surprising that the prevalent view is that section 49(1) does not apply so as to exclude the operation of section 48 on the death of a person entitled for an interest in possession in settled property. This interpretation is in any event clearly required by the context, as otherwise anomaly would result. The only situation in which section 49(1) is directly relevant to a charge to inheritance tax is on the death of the person beneficially entitled to the interest in possession in settled property. In that case, the charge is brought about through the combined operation of section 49(1), section 5(1) and section 4(1).

Now it is quite clear that, in the case of every other charge on settled property, it is the settled property excluded property rules contained in section 48 which are to apply. This is the case even where there is a charge under section 52(1) on the termination or disposal of an interest in possession during the lifetime of the beneficiary: see section 53(1). It would thus be highly anomalous if there were no charge on the termination of a life interest in possession *inter vivos* but there were on the death of the beneficiary if the life interest terminated only then and *vice versa*.

5 The Kessler Arguments

5.1 The Basic Argument

James Kessler favours the non-settled property solution at 17.10 and 17.11 of his *Taxation of Foreign Domiciliaries* (Key Haven 2001). He says, at 17.10.2:

> "The Non-settled property Solution seems persuasive at first glance, and has support from no less an authority than Robert Venables QC's *Non Resident Trusts* .... Nevertheless it was until recently almost universally accepted as wrong.
>
> What about the deeming provision that the property is to be treated as if the donor were beneficially entitled to it? The answer is that the property must still be regarded as 'settled property' for the application of the excluded properties.

> One way to reach this conclusion is to note that the deeming provision does not deem that in order to be beneficially and *absolutely* entitled to the settled property. One can be beneficially entitled to property which is settled property. (Bear in mind that 'settlement' has a wide definition for IHT. It includes property held subject to a contingency, property charged with the payment of an annuity, and a lease for life. A person entitled to such property may nevertheless be said to be 'beneficially' entitled.)
>
> That this is the correct construction is confirmed by section 49(1) which provides that:
>
>> a person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of this Act as *beneficially entitled* to the property in which the interest subsists.
>
> No-one suggests that property to which section 49(1) applies is not to be treated as settled property for the purposes of the GWR rules. The wording of the deeming provision in s.102(3) is the same."

5.2 Critique of the Basic Argument

I find it difficult to believe that section 49(1) is providing anything other than that the beneficiary entitled to the interest in possession is deemed to be beneficially entitled to the entire settled property free from the equitable interests of others under the settlement and thus to be beneficially *and absolutely* entitled. At least until I read Mr Kessler's views, I had always supposed that it was universally agreed that if a person is entitled to an interest in possession in the whole of the settled property, then he is deemed to be entitled to the whole of the settled property itself, i.e. that he is beneficially and absolutely entitled to the settled property.

Mr Kessler states in parentheses that the definition of "settlement" for inheritance tax purposes includes "property held subject to a contingency, property charged with the payment of an annuity, and a lease for life. A person entitled to such property may nevertheless be said to be 'beneficially' entitled". I find the truth of this terse statement to be by no means as obvious as Mr Kessler assumes it is. Indeed, I believe it to be wrong if I have correctly interpreted it.

Let us take the case of property subject to a contingency. Suppose I am entitled to an estate defeasibly on my marrying a Roman Catholic. Now while I am beneficially entitled to my defeasible interest, I am not beneficially entitled to the estate itself because "beneficially entitled" means "absolutely and beneficially entitled". If one asks what constitutes the settled property, it is the freehold interest vested in the trustees and not my determinable beneficial interest. If one asks to what section 49(1) deems me to be entitled, it is the freehold interest and not my defeasible beneficial interest.

Where property is held on trust for X for life but charged with an annuity in favour of Y, for inheritance tax purposes, each is deemed to be beneficially entitled to the income of an appropriate fraction of the settled property. See Inheritance Tax Act 1984, section 50. Now, in reality, neither the tenant for life nor the annuitant is beneficially entitled to any fraction of the settled property itself but to their respective beneficial interests. Yet I am sure that the effect of section 49(1) is to deem them to be beneficially and absolutely entitled to the respective fractions of the settled property in which their respective interests are deemed to subsist. X's executors cannot, in my view, argue that for inheritance tax purposes on his death one is to value the fraction of the settled property to which he is deemed to be beneficially entitled as being subject to the annuity.

What of the case of the lease for life? If it creates a settlement, the reversion on the lease is treated as the settled property. The lessee's interest in the property is to be taken to subsist in the whole of that property.[6] Hence, the lessee is deemed to be (absolutely) entitled to the reversion. See Inheritance Tax Act 1984, sections 43(3) and 50(6). I do not see how this assists Mr Kessler's argument.

Mr Kessler also states: "No-one suggests that property to which section 49(1) applies is not to be treated as settled property for the purposes of the GWR rules. The wording of the deeming provision in s.102(3) is the same". Those who favour the settled property solution do indeed advocate that "property to which section 49(1) applies is not to be treated as settled property for the purposes of the GWR rules". They would assert that if the settlor settles property on trust for X (not his spouse) for life and confers on the trustees an overriding power of appointment as to capital in favour of himself, then, assuming that to be a gift with reservation of benefit, the property which is in fact will be deemed to be comprised in the estate of the settlor immediately before his death; and it will be just as irrelevant that it is at that time deemed to be beneficially (and absolutely) owned by X as it would be if X were actually the absolute owner and there were a reservation in respect of it.

5.3 The Kessler Argument on Interest in Possession Trusts

In a continuation of the passage cited at 5.1 above, Mr Kessler continues:

> "The correctness of this is also confirmed if one considers a trust under which the settlor has an interest in possession. See below."

He states at 17.11 (Settlement in which donor has an interest in possession)

"Suppose:

(1) S (not UK domiciled) creates a settlement;

(2) S has an interest in possession in his settlement at the time of his death;

(3) the settled property is (accordingly)[7] subject to a reservation;

---

6 This is not the case to the extent that consideration was given for the lease. See section 170.

7 The property would not be property subject to a reservation simply because the settlor retained a life interest in it. See my *Inheritance Tax Planning* 3rd edition B.2.4.1 and *Commissioner for Stamp Duties New South Wales v Perpetual Trustee Company Limited* [1943] AC 425. This point, however, does not invalidate Mr Kessler's reasoning.

(4) the property is not UK situate at the time of the death.

Section 102(3), FA 1986 provides:

> "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." (Emphasis added)

The words in italics are here called "the donor's estate exemption to the GWR rule".

Adopting the Settled Property Solution, the position is easy to understand:

(1) The settled property is excluded property under s.43(3), ignoring s.103(3).

(2) Accordingly, apart from s.103(3), it does not form part of the estate of S immediately before his death; see s.5(1).

(3) Accordingly, the donor's estate exemption to the GWR rule does not apply and the deeming provision is s.103(3) does apply; but

(4) this does not matter as the property is excluded property for GWR purposes and treated as outside the estate of S at the time of this death.

Adopting the non-settled property solution, the position is as follows:

(1) The settled property is excluded property under s.43(3), ignoring s.103(3).

(2) Accordingly, as before, apart from s.103(3), it does not form part of the estate of S immediately before his death.

(3) However, applying s.103(3) and the non-settled property solution, it is not excluded property so does form part of the estate of S immediately before his death.

Thus the property is simultaneously excluded for one purpose and not excluded for another. This is possible but complex and clumsy and suggests that something is wrong with the non-settled property solution."

5.4 Critique of the Kessler Argument on Interest in Possession Trusts

Mr Kessler concludes: "Thus the property is simultaneously excluded for one purpose and not excluded for another. This is possible but complex and clumsy and suggests that something is wrong with the non-settled property solution". Now I am sure that Mr Kessler would agree that if I give away my Provencal home to my partner, who is not my spouse and who is domiciled in New South Wales, and continue to spend every summer there free of charge, then the home is property subject to a reservation on my death. It is at the same time (a) excluded property – if one is considering the estate of my partner – and (b) non-excluded property – if one is considering the application of the gifts with reservation of benefit provisions in relation to my death. It may be "complex and clumsy" to deem property which belongs to one person to belong to another for a *scintilla temporis*, but that is exactly what the gifts with reservation of benefit provisions do. It might be said once again that it can make no difference to whom the property subject to a reservation in fact belongs or whether it is in fact settled property.

6 Planning

One possibility of avoiding the gifts with reservation of benefit provisions is for the settlor to make a sheared gift. For example, if he were simply to gift the remainder expectant on his own life and were to retain a life interest by way of resulting trust, there would be no reservation of benefit. On his death he would be deemed to be beneficially entitled to the settled property as settled property. It would rank as excluded property and thus not increase the tax exigible on his death.

If the settled property at any stage consists of an interest in land. Finance Act 1986, sections 102A-102C, inserted by Finance Act 1999, must be taken into account.

Another possibility is so to construct the trusts that any gift in settlement constitutes an exempt transfer of value by virtue of the spouse exemption contained in Inheritance Tax Act 1984, section 18, thus bringing into play Finance Act 1986, section 102(5)(a). See *IRC v Eversden* [2002] STC 1109. It is crucial to ensure that the gift in settlement does constitute a transfer of value and one which fails to qualify as a chargeable transfer of value merely on account of the spouse exemption. Thus, there will be no point in the settlor gifting excluded property, as that would not constitute a transfer of value at all: Inheritance Tax Act 1984, section 3(2).

It is sometimes suggested that the settlor should be given a life interest in the settled property;[8] he will thus be deemed to be beneficially entitled to the settled property by virtue of section 49(1); the settled property is, as such, excluded property; hence on the one hand it falls to be disregarded in computing the value of his estate on his death and on the other hand Finance Act 1986, section 102(3) cannot apply to it. The weak link in the argument is the last one. Section 102(3) is not prevented from applying simply because the deceased donor was beneficially entitled to the property in question. It is necessary that it formed part of the donor's estate immediately before his death. Yet as it is, *qua* settled property, excluded property, section 5(1) expressly provides that it does not form part of his estate. Thus section 102(3) can operate, which brings one back to the vital question of which set of rules one applies to determine whether or not the property is excluded property.

7 Conclusion

The accepted construction of section 49(1) can, of course, work to the benefit of the Revenue, as where a non-UK domiciled tenant for life dies entitled to an interest in possession in a non-excluded property settlement. So. too, my view of section 102(3)

8 There can be good reasons why this should not be an immediate life interest: see Inheritance Tax Act 1984, sections 80 and 82, discussed at D.15.2.4 of the third edition of my *Inheritance Tax Planning*.

can work to the advantage of the taxpayer, as where a settlor establishes a trust while he is UK-domiciled, but becomes non-UK domiciled before his death.

At the end of the day, the interpretation of section 102(3) is a matter of law. As such, it will fall to be determined by the Appellate Committee of the House of Lords. One must ask how high is the probability of their Lordships giving section 102(3) a construction which will facilitate the avoidance of tax by persons of foreign extraction who have become firmly settled in this country. Of course, I accept that the House of Lords showed in *Fitzwilliam v IRC*[9] that it is capable of giving the green light to the most technical of tax avoidance schemes, while the decision not to give effect to the July 1988 Consultative Paper on residence of individuals by tightening up the rules affecting long-term UK residents with a foreign domicile showed that foreign domiciliaries still had, at least at that time, considerable political clout. Yet times are now changing. It is therefore possible that the Capital Taxes Office will one day take the point. It is also possible that it could be raised in the case where it was in the taxpayer's interest to do so.

---

9 [1993] STC 502.