GROB AVOIDANCE BY INTEREST IN POSSESSION TRUST FOR SPOUSE

Robert Venables QC

1 The Strategy

I suggested in my *Tax Planning Through Trusts Volume 1 Inheritance Tax Planning*[1] that it should be possible to set up a trust under which the settlor could benefit without bringing into play the IHT GROB provisions. I quote:

> "5.6.7 Initial Interest in Possession for Spouse of Settlor
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> "5.6.7.1 Exempt Transfer of Value
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> "A gift to a settlement under which the settlor's spouse enjoys an IIP will normally constitute a transfer of value as the settlor's estate will be diminished in value by the gift. The precise extent of the diminution will depend upon what interest the settlor retains in the settled property.
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> "Provided the settlor's spouse is domiciled in the United Kingdom, however, the transfer of value will normally be entirely exempt. The settlor's spouse will be deemed to own the settled property by virtue of IHTA s.49(1) and thus the entire transfer of value will be attributable to property which becomes comprised in the estate of the transferor's spouse: IHTA s.18(1).
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> "Although the settlor will almost certainly have made a gift, FA 1986 s.102 will not apply as it is in terms excluded by s.102(5)(a). Hence, the settlor may reserve whatever benefits he wishes over the settled property. The position is the same as if FA 1986 had not been enacted.
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> "The s.102(5)(a) exemption will come into play only if the gift in settlement constitutes a transfer of value and one which is exempt by virtue only of the spouse exemption. A gift of excluded property, for example, would not constitute a transfer of value at all. See 6.2.1.

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[1] Published by Key Haven Publications PLC, January 1990.

"5.6.7.2 Planning

"It might be tempting to ask whether it would not be appropriate, wherever the settlor wishes to reserve an interest under a settlement, other than an IIP, for the first trust to be an IIP for the settlor's spouse for a comparatively short period, say, six months or the life of the settlor's spouse, whichever is the shorter.

"Suppose this were done purely with tax planning in mind would the motive prevent the same result from obtaining? Certainly there would be no question of a disposition by associated operations. There would be only one operation.

"It might be objected that the doctrine in *Furniss v Dawson* would apply as the initial IIP in favour of the spouse would have been inserted only for tax-avoidance reasons. In my view, which is reinforced by the decision of the House of Lords in *Craven v White*, it would not apply in the present circumstances. It has applied hitherto to a series of transactions where a step is inserted for fiscal reasons. In the present case, there will be only one transaction, the making of the gift to the trustees of the settlement. The trust would simply be designed so as to be tax-effective. Moreover, there would be nothing artificial about the gift in favour of the wife. It would be very real as she would be genuinely entitled to the income of the settlement for the six-month period. Put another way, there will be a difference in substance corresponding exactly to the difference in form. All that the settlor would have done would have been to choose to make a tax-efficient gift. So much must surely remain of the authority of the *Duke of Westminster* that where a taxpayer can choose between two different transactions and opts for the tax-effective one on account of its fiscal advantages, he is not to be taxed as though he opted for the fiscally more onerous one.

"The utilisation of an initial IIP for the settlor's spouse will have other important consequences. On the termination of the spouse's IIP, the settled property is to be taxed as though he or she has made a transfer of value, the value transferred being equal to the value of the settled property: IHTA s.52(1): see 11.4.2. However, since the passing of F(No 2)A 1987, the transfer could well qualify as a PET: see 4.7. Even if the transfer were chargeable, taxability would be by reference to the history of the spouse's cumulative chargeable transfers of value in the period of seven years ending with the date of termination of his or her interest rather than by reference to the settlor's chargeable transfers of value made in the period of seven years immediately preceding the date of the gift in settlement by him. The new alternative charge provisions would not bite. See 4.9.6.4.

"Great care must be taken if the gift by the settlor is of property qualifying for business or agricultural relief. Relief which might be available if the gift in settlement constituted a chargeable transfer of value by the settlor would not necessarily be available on the termination of a short IIP to which the settlor's spouse had been beneficially entitled.

> "Where the trust will at some stage become discretionary or the settled property otherwise constitute "relevant property" within the meaning of IHTA s.58, periodic and exit charges to IHT levied under Part II Chapter III IHTA will be calculated on the assumption that the property became settled property only on the termination of the initial IIP of the settlor's spouse and on the fictitious basis that the spouse was the settlor. See 13.3.7.
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> "If a short IIP vested in the settlor's spouse is to be followed by discretionary trusts, whether immediately or sometime in future, the special rules concerning the qualification of the settled property as "excluded property" must be borne in mind. See IHTA s.82 and 13.3.7 and 17.2.4."

2 The Objection

It is stated in McCutcheon on Inheritance Tax, 1988 edition, at 6-17 under the heading *Exploitation of exemptions*:

> "The suggestion has been made that it may be possible for a donor to sidestep the reservation of benefit provisions by settling property on his spouse for life, remainder on discretionary trusts under which he is one of the beneficiaries. The argument would be that the entire transfer into trust would be covered by the spouse exemption, with the result that the reservation of benefit provisions were prevented from applying by section 102(5). The authors feel somewhat uneasy about this approach because section 102(5) does not refer to a *transfer of value* being exempt. Rather it refers to a gift being exempt, and in the example it may be arguable that the donor makes two separate gifts - one of the life interest to his spouse (which is exempt) and one of the reversion to the discretionary class, which is not exempt."

This is hardly what one would call a forcefully expressed opinion. Nevertheless, it has apparently deterred some taxpayers from undertaking the strategy. Is there anything in it?

3 My Answer

FA 1986 Section 102(5) provides:

> "This section does not apply if, or as the case may be, to the extent that the disposal of property by way of gift is an exempt transfer by virtue of any of the following provisions of Part II of the 1984 Act.[2]
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> (a) section 18 (transfers between spouses) ..."

What is an "exempt transfer"? IHTA 1984 s.3(1) provides that "a transfer of value" is "a disposition made by a person (the transferor) as a result of which the value of his estate immediately after the disposition is less than it would be but for the disposition ..."

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[2] The IHTA.

There is no real definition of an "exempt transfer". IHTA s.18(1) provides:

> "A transfer of value is an exempt transfer to the extent that the value transferred is attributable to property which becomes comprised in the estate of the transferor's spouse or, so far as the value is not so attributable, to the extent that that estate is increased."

Thus, if I make a gift in settlement to be held on trust for several persons I have made only one disposition. To determine to what extent it is a transfer of value one asks by how much my estate has been decreased in value. To determine to what extent it is exempt one asks firstly whether it is attributable to property which becomes comprised in the estate of my wife.

The GROB legislation uses the central concept not of transfer of value but of "disposal of property by way of gift". That phrase, together with most of the GROB provisions, was taken out of the estate duty cold storage to which they had been consigned more than a decade previously. It must always be remembered that they do not easily dovetail into the rest of the IHT legislation.

Now the authors of McCutcheon claim that s.102(5) refers to a *gift* being exempt. Yet close examination of the provision will show that it does not. It does not even refer to an exempt *disposal* (by way of gift) - which is hardly surprising, as there is no such thing as an exempt disposal by way of gift. It asks one to consider whether a disposal by way of gift *is* an exempt transfer. Now only transfers of value can be exempt and they are strictly speaking not disposals but dispositions. It is therefore clear that what we are being asked to consider is whether something which is a disposal of property by way of gift also happens to be a disposition which is an exempt transfer of value. To my mind, that necessarily colours what is meant by "disposal by way of gift". If there is only one disposition and one transfer of value, so too there must be only one disposal.

Such a conclusion is that to which common sense would lead us. If I transfer an asset to trustees to be held on the trusts of a settlement, we would naturally say that I had made one disposal, not two, three, or, for that matter, three thousand disposals. If McCutcheon is right, why are there in his example only two gifts? Is there not, for example, a separate gift to each and every member of the discretionary class? And in that case what has been gifted to each? And what if some of them are not ascertained or in being? To whom then has the gift been made? The short answer if that the one disposal may have created many "gifts" in the sense of beneficial limitations but there is still only the one disposal. It is simply not true that if I dispose of property so as create several "gifts" that I have disposed of several different pieces of property. In McCutcheon's own example, is it not absurd to say that the settlor has disposed of each of the interests to which each of the discretionary beneficiaries have become entitled? The reality is that he has disposed of one piece of property (what has become the underlying trust property) so as to create several different items of property, namely the equitable interests of the beneficiaries.

Does my construction give rise to absurdity? Suppose I gift shares to trustees upon trust to pay 5% of the income to my wife and 95% to my children with power to appoint the whole back to myself. In my view, there is one disposal but it will be saved from the GROB provisions only as to 5% of the property gifted by virtue of the words "to the extent that the disposal by way of gift is an exempt transfer". On McCutcheon's view, it is difficult to see how these words could have any effect. If there is a separate disposal by way of gift to the wife, the whole of it must be exempt.

The more one "bakes" the McCutcheon view, the stranger the cookie seems. Suppose that the gift is to my wife for life, remainder on discretionary trusts of which I am not an object, remainder over to charity, the trustees having power to appoint the capital back to me at any time during my life. I predecease my wife without the power having been exercised. What exactly would McCutcheon say is deemed to be comprised in my estate immediately before my death?