The Personal Tax Planning Review

GIFTS TO COMPANIES: AVOIDING THE GROB PROVISIONS

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1 Scope of the Article

In this article I firstly consider the general inheritance tax advantages and disadvantages of gifts to companies. I then discuss a strategy I have discovered which appears to circumvent the effect of the gifts with reservation of benefit provisions. The precise scenario I have in mind for its use is a donor with an asset for sale which qualifies for 100% business property or agricultural relief from inheritance tax and for hold-over relief under Taxation of Chargeable Gains Act 1992 section 165. He would like the proceeds not to form part of his estate for inheritance tax purposes but would like to be able to benefit from them if need be. He is reconciled to having to pay capital gains tax on the sale. Other variants on this theme are possible.

2 Is there a Transfer of Value?

2.1 Gift to Transferor-Owned Company

A gift to a company may or may not involve a transfer of value on the part of the transferor. That will depend on the nature and extent of his shareholding in the company. If it is extensive enough, it may prevent any, or any appreciable, diminution in the value of his estate. For although the asset gifted will cease to belong to him, his shares will rise in value.

Suppose the transferor owns all the share in a company. The rise in value of his shares may not compensate for the diminution in the value of his total estate as a result of the loss of the asset gifted. It might be thought that provided there was no intention on his part to confer any gratuitous benefit on any person, section 10

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Inheritance Tax Act 1984 would come to the rescue and prevent his making any transfer of value. The position, however, is not so simple.

Section 10, it will be recalled, provides that a disposition is not a transfer of value if it is shown that it was not intended, and is not made in a transaction intended, to confer any gratuitous benefit on any person and either -

(a) that it was made in a transaction at arm's length between persons not connected with each other, or

(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.

Although the gift may well fall within the spirit of the section, the actual wording is very difficult. In a sense, the transferor clearly does intend to confer gratuitous benefit on a person, namely the company. Could it be said that the benefit is not gratuitous in that the primary motive of the transferor is not to benefit the company but to benefit himself?

In the circumstances envisaged, the transferor will certainly be connected with the company. Condition (a) is thus not satisfied. Furthermore, it is difficult to see how condition (b) can be satisfied. If the transferor and the company were not connected with each other, he clearly would not have made the gift. For he could only fail to be connected with the company if he owned substantially less than the entire share capital: see Inheritance Tax Act 1984 section 270 (definition of "connected persons", incorporating Taxation of Chargeable Gains Act 1992 section 286, with modifications).

2.2 Gift to Company in Which Spouse Interested

It might be thought that where the transferor and his UK domiciled spouse are the only persons interested in the share capital of the company, then there cannot conceivably be any chargeable transfer of value. Technically, however, this must be doubted. Suppose the transferor and his spouse each to own beneficially 50% of the issued share capital of the company. The transferor gifts to the company land and buildings used by it for the purposes for its business. The rise in value in the share capital is less than the value of the property. The estate of the transferor will have been considerably diminished in value. Before the gift, he will have owned the whole property and after the gift his shares would have risen in value to the extent of less than half the value of the property.

The inter-spouse exemption contained in Inheritance Tax Act 1984 section 18 applies only 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 transferred is not so attributable, to the extent that that estate is increased. The first limb of section 18(1) will not be satisfied, as the property will become comprised in the estate of the company. Thus, provided the rise in value in the spouse's shares is at least equal to one half of the value of the property gifted there should be no problem. But in any other case, full exemption will not be available. This difficulty is not so great as might at first be thought. At least, in valuing the shares of the husband and wife one will apply the related property provisions and value each holding as a proportionate part of the combined whole: see Inheritance Tax Act 1984 section 161.

I have been assuming hitherto that the measure of the transfer of value is the value of the gifted property. In many cases, this will be the case. As the measure of the transfer of value is calculated by reference to diminution in the value of the estate of the transferor, however, there may be cases where the value transferred is greater than the value of the property taken in isolation. *Prima facie*, this compounds the problems mentioned above. It may be possible, however, to place some reliance in the principle of valuation expounded in *Attorney General of Ceylon v Mackie*.[2]

2.3 Charitable and other Exempt Gifts

Care must similarly be taken where the gift is to a company wholly owned by a charity or other body a direct gift to which would be exempt.

3 Gifts to Companies as Potentially Exempt Transfers

Given that a gift to a company is a transfer of value, can it be potentially exempt? Inheritance Tax Act section 3A(1)(c) provides that a potentially exempt transfer is a transfer of value to the extent that it constitutes either a gift to another individual or a gift into an accumulation and maintenance trust or a disabled trust. Prima facie, therefore, a gift to a company does not qualify. Section 3A(2) at first sight looks promising in that it provides that a transfer of value falls within subsection (1)(c) as a gift to another individual, "(b) so far as that value is not attributable to property which becomes comprised in the estate of another person, to the extent that, by virtue of the transfer, the estate of that other individual is increased". Can the gift therefore qualify to the extent that it increases the estate of individual participators in the company or of settled property held on interest in possession, accumulation and maintenance or disabled trusts?

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2 [1952] 2 All ER 775. See my *Inheritance Tax Planning 3rd edition* at G.7.3.1.

Suppose, for example, B beneficially owns the whole share capital of a solvent company. A makes a gift to that company. The estate of B will thereby be increased in value, in that his shares in the company will rise in value to an extent almost as great as that of the gift. Section 3A(2)(b) would therefore apparently be satisfied.

The appearance is not the reality. Limb (b) is to operate only "so far as" the value transferred "is not attributable to property which becomes comprised in the estate of another *person*". "Person" clearly includes a company and a company can equally clearly have an estate and, indeed, make a transfer of value. Hence, no relief is available under limb (b).

That, however, is not the end of the story. The draftsman has not in my view been astute enough to cover the following case. The facts are as before except that instead of gifting cash, A deliberately allows to lapse a valuable option he has to purchase property owned by the company. In this case, A's transfer of value will not be attributable to property which becomes comprised in the estate of the company. It can therefore qualify as a potentially exempt transfer to the extent that, by virtue of the transfer, the estate of B, the individual participator, is increased. B's estate will, of course, be increased as his shares in the company will rise in value. Possibly, the increase in value will not be totally commensurate with the extent of A's transfer of value, so that it will not qualify as a potentially exempt transfer in its entirety.

Where ownership of the "donee" company is split amongst two or more participators, some of whom are individuals, then it will normally be the case that the total increase in the value of the shares as a result of A's transfer of value will be substantially less than the value thereby transferred. In such a case, however, A's transfer should still qualify in part as a potentially exempt transfer to the extent to which the value of the individuals' shareholdings were enhanced.

4 Reservation of Benefits

4.1 The Use of Companies Generally

The introduction of the gifts with reservation of benefit provisions has ensured that in the normal case where inheritance tax planning is in mind, all but the most hardy settlors reserve no benefit whatsoever under their settlements. Companies offer much greater opportunities for "shearing" and de facto reservation of benefit while avoiding the application of the gifts with reservation of benefit provisions than do trusts alone. It will often be possible to achieve a similar result by means of a "shearing" exercise, involving the creation of different classes of share capital and/or securities in or over the company, some of which will be retained and some gifted.[3] This planning is not affected by the Court of Appeal decision in *Lady Ingram's Executors v IRC* on 28th July 1997.

4.2 Problems with Gifts to Companies

Such strategies need not involve any gift *to* a company. Where there is a gift to a company and the donor retains some interest in the company, the effect of the application of the gifts with reservation of benefit provisions is somewhat problematical. One could argue that there is no reservation of benefit because possession and enjoyment of the property gifted is bona fide immediately assumed by the donee, i.e. the company, within Finance Act 1986 section 102(1)(a), and that the property will be enjoyed by the donee company to the entire exclusion of the donor, within section 102(1)(b), so long as the donor does not actually receive a benefit from the company referrable to the property gifted, e.g. the payment of a dividend.

Let us assume, erring on the side of caution, that a gift of an asset to a company will be subject to a reservation of benefit if and to the extent that the donor is a shareholder in the company or is capable of benefiting under a settlement which has a direct interest in the donee company. If that state of affairs continues until the death of the donor, the gifted property (or property representing it under the rules contained in Finance Act 1986 Schedule 20) will be deemed to form part of his estate immediately before his death if it would not otherwise have done so and will thus be liable to inheritance tax at that time.

Suppose that the donor has a 1% beneficial in the donee company and that the rest of the share capital is held on trusts under which he is excluded from benefit. There is a theoretical argument that the *whole* of any property gifted by him to the company will be property subject to a reservation.

5 Capital Gains Tax on Gifts to Companies

It should not be forgotten that on the disposal of any asset otherwise than by way of bargain at arm's length, the person making the disposal is deemed to receive a consideration equal to the market value of the asset: Taxation of Chargeable Gains Act 1992 section 17. While hold-over relief for gifts to companies resident in the United Kingdom is available in certain cases, it is not as extensive as that in respect of gifts to individuals and settlements. Taxation of Chargeable Gains Act

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3 An example is the type of share reorganisation discussed in my *Inheritance Tax Planning 3rd edition* at F.4.3.

1992 section 165 and Schedule 7 do apply (gifts of interests in trades, trading companies and agricultural property), but section 260 (gifts which are chargeable transfers) does not.

6 A Strategy

Suppose that a donor has an asset for sale which qualifies for 100% business property relief from inheritance tax and for hold-over relief under Taxation of Chargeable Gains Act 1992 section 165. He would like the proceeds not to form part of his estate for inheritance tax purposes but would like to be able to benefit from them if need be. He is reconciled to having to pay capital gains tax on the sale.[4]

If the settlor is already a beneficiary of a suitably worded settlement created by someone else, such as his late father, that can be used. If not, some benevolent person, such as the donor's spouse, should create one with a modest donation and exclude themselves from any benefit. The settlement would acquire a UK resident holding company with £2 of issued share capital. The settlor would then gift the asset to the company. The trustees could then, if they thought fit, sell the shares in the company to an unconnected third party.

The gift will be to the holding company. If the shares in the holding company are sold, the reservation of benefit will cease at that stage. The donor will no longer have any interest, direct or indirect, in the gifted asset itself. Curiously enough, the provisions of Finance Act 1986 Schedule 20, especially paragraph 2 (substitutions and accretions) will not apply as there will not be a sale of the gifted asset but of the shares in the donee company. Even if paragraph 2 did apply later because the holding company sold the previously gifted asset, the donor would still have no interest in the proceeds of sale or other property into which the holding company might re-invest them. Most importantly, paragraph 5 of Schedule 20 would not apply as the property comprised in the donor's gift would not have not become settled property by virtue of the gift.

The result would be that while the donor could continue to be a beneficiary of the trust, the settled property would not be, in relation to him, property subject to a reservation, even though he had-provided virtually all of its value.

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4 The following account is very much a "bare bones" one which requires careful consideration and possibly adaptation in the circumstances of any particular case.