SPLITTING UP THE HOME

Nil rate band discretionary trusts

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BASIC INHERITANCE TAX planning for husband and wife requires that each partner should make full use of the nil rate band. The nil rate band for 1996-97 is 200,000 so the use of it may save tax of 80,000.

In what follows it is assumed for simplicity that husband and wife own their home in equal shares; and the husband dies first, leaving a widow.

Under arrangements commonly made, the husband's will makes a gift of the nil rate sum to a discretionary trust set up by his will. When the husband dies, and his will takes effect, there is often no convenient cash or investments to satisfy this gift. The husband can only use his nil rate band by dealing with his share of the family home. Let us assume it is worth half the nil rate band.

This all too common situation raises a number of difficulties and a variety of solutions have been canvassed in the periodicals (as noted at the end of this article). The purpose of this article is to discuss a current Revenue attack on one method commonly used.

Under this method, the husband's share of the family home is transferred to the discretionary trust in satisfaction of the gift made in the will.

The position then is that the house is held in two shares:

(1) one half is held by the widow directly; *and*

(2) the other half is held by the discretionary trust.

The widow then continues to live in the property until her death.

If the husband dies leaving everything under his will to his widow, the same arrangements have often been set up by deed of variation.

On the death of the widow, her own share of the house is part of her estate and subject to inheritance tax. The value of the half share will be less than half of the value of the whole house. This is an added attraction of the arrangement.

The trust's half of the house does not belong to the widow, does not form part of her estate, and is not subject to inheritance tax on her death.

This strategy is as old as capital transfer tax. It has now come under Revenue attack. The Revenue view is that the widow acquires an interest in possession in the trust fund. If she has an interest in possession, she is treated for inheritance tax purposes as if she owned the trust fund: section 49, Inheritance Tax Act 1984. Accordingly she will be subject to inheritance tax on the entire house, not just on her own half share of it.

It is reported that the Revenue now tracks those cases where such arrangements are set up, in order to raise an assessment on the death of the widow.

Some cases have reached the stage where a notice of determination has been raised.

The Revenue view

The Revenue view is simple. The trustees have given the widow the right to exclusive occupation. That right is an ‘interest in possession’ in the trust property.

There are three main counter arguments.

The first argument is that the trustees give the widow no benefit from the trust property at all.

The second argument is that the trustees do indeed give the widow some benefit from the trust property, but that benefit is not an ‘interest in possession’.

The third argument is that the widow enjoys some benefit from the trust property, but in breach of trust. A benefit enjoyed in breach of trust cannot amount to an interest in possession: the widow can only have an interest in possession if the trustees validly exercise their powers to give her that interest.

The three arguments raise different areas of law, each fascinating. The technical points will only be summarised here: a complete discussion would fill this entire issue of Taxation.

The first argument: land law

The first argument denies that the trustees give the widow any benefit from the trust property.

The focus here is on the land law cases on co-ownership. They show the limited rights of the trustees as mere co-owners of the home. As owner of a half share, the widow has a right of occupation. As the owners of the other half share, the trustees could allow other beneficiaries to occupy the property.

In fact the other beneficiaries will have chosen not to do so. That is a matter for them; but the Revenue does not argue (and cannot argue) that this act of the *beneficiaries* gives the widow an interest in possession.

The most promising answer for the Revenue is to say that the trustees could have applied to the court to sell the property or receive some rent and their failure to do so gives the widow an interest in possession. But on the present land law authorities (the

leading case is *Dennis v McDonald* [1982] Fam 63) the trustees would probably not succeed in obtaining either a sale of the home or rent from the widow. The decision of the trustees not to pursue proceedings which would fail in court can hardly be said to confer any interest at all on the widow, let alone an interest in possession. (Similar arguments are raised in other more esoteric tax contexts, in cases of co-ownership. The point may arise in connection with the Schedule E charge on the provision of living accommodation by employers or companies: sections 145 and 146, Taxes Act 1988. The point occasionally arises for offshore trusts providing property to beneficiaries.)

The second argument: tax law

The second argument is that *if* the trustees do in fact give the widow some benefit from the trust fund, that benefit falls short of an interest in possession.

The focus here is on the cases (mainly capital transfer tax cases) defining 'interest in possession'. An interest in possession must have a degree of permanence: the interest of a beneficiary under a discretionary trust lacks that.

The closest case is *Swales v Commissioners of Inland Revenue* [1984] STC 413: here the beneficiary received all the income of the trust fund, following a trustee resolution to pay the income to

him; yet he had no rights to the income and no interest in possession.

The argument here proceeds by analogy with *Swales*. The widow's benefit from the trust - that the trustees will not exercise their rights of co-ownership - is precarious, transitory and does not have the nature of an 'interest in possession'. There are no authorities directly in point but in principle this argument is attractive.

The third argument: trust law

The third argument arises only if the first two fail. So it must be assumed (contrary to the first argument) that the trustees gave the widow benefits over the trust fund, in the form of exclusive occupation. It must also be assumed (contrary to the second argument) that such a benefit amounts to an interest in possession for inheritance tax purposes. The argument here is that the trustees must have acted in breach of trust. Whatever the trustees may have intended to do, they have not validly exercised their powers. So the widow cannot have an interest in possession.

The focus here is on the trust law cases regulating the exercise of trustees' powers. There are a variety of arguments in this category.

One issue which will often arise here is whether the trustees ever properly considered the exercise of their powers; if they did not, then they cannot have exercised them properly. The strength of this argument will depend on the facts of each case.

There is a variant of this argument which would apply in all cases. Trustees' powers are only validly exercised if the trustees have taken into account all relevant factors, including tax. The leading case in this area is now *Mettoy Pension Trustees v Evans* [1990] 1 WLR 1587. Since it would be against the interest of the beneficiaries (indeed, arguably, a breach of trust) to create an interest in possession, the power *cannot* have been validly exercised. The widow cannot possibly have been given an interest in possession.

Another argument in this category is based on the rule that an interest in land can only be created by a written document signed by the trustees (see section 53(l)(a), Law of Property Act 1925). In the absence of some written direction by the trustees, no beneficiary can have an interest in possession. In many cases there will be no such document.

Conclusion

Which of these arguments is right? In the writer's view, all three! Though it must be said that the first is stronger than the second,

and the third argument may appear overly technical to some judges. The case in total is, in the writer's view, almost unanswerable. While the strength of individual cases will vary, according to their facts, my conclusion is that there will but rarely be sufficient basis for the Revenue attack to succeed.

Trustees should resist the Revenue view firmly.

Future planning

At the present time uncertainty prevails. Until the law is settled, it might be better not to set up such arrangements for the future. There are many suitable alternatives. But where such arrangements have been set up already, and the widow is presently living in the home, the writer would not at present be inclined to disturb the existing arrangements.

Advance warning

The position may quite soon be altered. The Trusts of Land and Appointment of Trustees Bill proposes substantial (in the eyes of land lawyers, revolutionary) changes in land law. Clause 13 of the Bill will give trustees power to charge the widow for her occupation of the house which they jointly own.

The law reform will knock away the first and most powerful of the arguments set out above.

Fortunately, for the discretionary will trusts considered here, the second and third arguments still remain. (The Bill has important implications when there is joint ownership of property by employees and companies, or by beneficiaries and offshore trusts. But that is beyond the scope of this article.)

The Bill has had its second reading, and will very likely become law before the end of the parliamentary session in November. The Bill will take effect from a date to be appointed by statutory instrument; there will probably be considerable delay. When the Bill finally takes effect advisers of these discretionary trust arrangements will need to consider its possible impact. Some amendments to the Bill are likely and comment at this stage would be premature. Instead I hope to return to the topic in due course, with an update.

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