THE PRINCIPAL PRIVATE RESIDENCE

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INTRODUCTION

This article is now out of date; it is only retained online because it is referred to in earlier editions of Drafting Trusts & Will Trusts.

This article reviews a range of tax planning strategies relating to the principal private residence of a UK domiciled individual.

The family home should in principle be an easy subject for tax planning.

The home produces no income, so the income tax rules can be largely (though not entirely) ignored.

The home enjoys the benefit of generous CGT exemptions. These in fact are the cause of much difficulty, for while it is often not difficult to mitigate IHT on the family home, there may be little advantage in doing so if, as so easily happens, the CGT exemption is thereby lost.

There is the additional difficulty that the home owner - no matter how keen to avoid the burden of taxation - will often not be prepared to contemplate any courses of action which threaten his security in his own home. This does not mean that tax planning for the home is ruled out: rather, questions of security of tenure must be anxiously considered. This article touches on these questions, but does not attempt a full discussion of the land law aspects.

While the issues of tax law here discussed should apply with equal validity on both sides of the border, the land law considered is that of England and Wales, and the position in Scotland will need independent review.

PART ONE: WILL PLANNING FOR THE FAMILY HOME

Begin with the most common situation: a married individual owns his home; and he prefers to retain absolute ownership of the property during his lifetime, not being prepared to contemplate any tax planning steps during his lifetime.

The question arises: how he should provide for the property to pass under his will? Or after death, should the provisions of the will be varied by deed of variation? Assume at this stage that the testator's nil rate band is used up by other gifts.

Bequest to Spouse Absolutely

The natural course is that the property should be given by the will to the spouse absolutely if she survives him.

This has many advantages. It is simple in concept and involves a minimum of legal and administrative expense. The owner of the property has complete security of tenure during his life, as does his spouse after his death. The capital value of the property is available should either of them need it.

From a CGT viewpoint the arrangement operates favourably: principal private residence relief will be available if the property is sold at any time.

From an IHT viewpoint there will at least be no tax charge on the first death.

The drawback is simple and obvious: there will be an IHT charge on the death of the surviving spouse. If the nil rate band is used up by other assets, the cost of doing, effectively, nothing amounts, at current tax rates, to 40% of the value of the property. The rate of tax will be that in force at the time of death. The rate actually suffered by the estate of the widow may very well exceed the present rate, which is historically low.

It should be noted that this strategy is, from a tax viewpoint, perfectly acceptable in cases where the value of the spouse's entire estate after the death will not substantially exceed the nil rate band (now 128,000).

Another possible disadvantage of this route is that the owner of the property may not wish his spouse to have freedom to dispose of it after his death. He may wish to ensure that the property passes to his children. In such cases, a will trust will be needed for the property.

Will Trust for Spouse

In the area of the family home, as in almost every other, settlements offer intriguing possibilities for tax planning.

Settlement in traditional form

A very common will form provides that a testator's property (or his share in it) should be held by his trustees:

"on trust .... for my widow during her life with remainder to such of my children who survive me [with provision for any family of those who do not] in equal shares absolutely."

The practical difference between a simple and unsophisticated settlement such as this and an absolute bequest to a spouse is this: under the settlement, the children will take the house on their mothers death. The trust ensures that the property (less tax, however) will remain within the family.

The widow may need capital from the property to support herself. To cater for this situation, it is suggested that the trustees of the settlement should as a matter of course be given power to advance trust capital to the widow. With this refinement a simple settlement along these lines is a reasonably effective, if not ideal, means of dealing with the family home by will.

The tax position is the same as an absolute gift to the spouse. CGT relief is in principal available on any sale of the property: s. 104 CGTA 1979.

For IHT purposes the gift is treated as a gift to the spouse; there will be a tax charge on the second death. This is the disadvantage of a simple will trust.

Recommended Form of Will Trust

It is not too difficult to devise arrangements which may mitigate the IHT liability. It is more of a challenge to find a means of doing this without losing the CGT private residence relief.

The present proposal is as follows:-

(1) The testator should leave his home to trustees to hold on trust for sale and on the following trusts:

(a) For the widow for life, with remainder to (say) the testator's children.

(b) Notwithstanding (a) above the trustees have a wide power of appointment by which they may revoke the trusts of (a) and appoint such new trusts for the benefit of the testator's family (and, possibly, others) as they think fit.

(2) The testator should sign a letter of wishes setting out his long term wishes for the property. This is for the assistance and guidance of the trustees, but would not bind them. (Such a letter is desirable though not essential.)

(3) After the death of the testator, the trustees will consider (in the light of the tax law as it then is) whether they should exercise their power of appointment so as to appoint that the trust fund is held on trust:

(i) to pay one tenth of the income to the widow;

(ii) to pay the remainder of the income to the children;

but subject to any further exercise of the overriding power of appointment.

(4) The widow will continue to enjoy the property. The trustees will take appropriate indemnities from the children.

It is thought that these proposals are favourable for IHT and CGT purposes.

The IHT Position

First, of course, there is generally no IHT charge on the death of the testator, since the trust fund passes to a settlement under which his widow has an interest in possession: s.18(1) IHTA 1984.

The partial termination of the widow's interest in possession at stage (2) is a potentially exempt transfer. Accordingly no tax is exigible if the widow survives seven years. If she dies within the seven year period, tax is chargeable by reference to values and rates of tax on the date of the trustees' appointment and not the date of death. A reduced rate of tax is payable if she survives more than three years.

The termination of the widow's interest in possession is not a "disposal by way of gift" so s.102 FA 1986 (gifts with reservation) does not apply. This is still considered to be the case if the widow is a trustee or even the sole trustee; though the ultra - cautious advisor might prefer the widow not to be a trustee, in case the Revenue should take a different view.

Position on Death of Widow.

It is considered that, after the trustees exercise their power for appointment, the widow has an interest in possession in one tenth of the trust property. This follows necessarily from s.50 IHTA 1984.

The result is that, on the death of the widow, there is an IHT charge on one tenth of the value of the property. See s.52(4)(a) IHTA 1984.)

After the widow's death the trustees will need to decide how to apply or on what trusts to hold the property. The testator's letter of wishes will be of assistance to the trustees in making this decision.

Death of Children.

Appropriate provision would need to be made for the possibility that the children might predecease their mother, but that should not cause great difficulty.

CGT on Sale of the Property.

It is thought that the property can qualify for full private residence relief for CGT on a sale at any time during the widows lifetime or up to two years after her death. For the settled property will be the sole or main residence of a person who is "entitled to occupy it under the terms of the settlement". See s.104 CGTA 1979.

The widow is so entitled by virtue of her one tenth interest in possession in the property, combined with the trustees' exercise of their powers of management authorising the beneficiaries in possession jointly to occupy the property. Such a power may be implied (this is a contentious question of property law) but in practice the trustees would have an express power so drafted that the trustees could not give the widow a joint (not exclusive) right of occupation.)

Although the widow's occupation depends on the trustees' discretion, this is still occupation "under the terms of the settlement"; see Sansom v Peay 52 TC 1.

Admittedly the widow is jointly and not solely entitled to occupy. That does not matter. It is a fundamental principle of land law that a joint owner of property (under a joint tenancy or a tenancy in common) is entitled to occupy the whole of his property jointly with his co-owner. To construe the legislation as conferring a partial CGT relief in such circumstances, however desirable that might be to the Revenue, would not be permissible under the accepted canons of construction.

If CGT is exigible (for instance if the property is not the widow's main private residence) then the rate of tax is 25%, not 40%. Contrast the position if the children are absolutely entitled to the property.

Security of Tenure.

The widow's tenure in the property is reasonably, if not absolutely secure. The will being properly drafted, the trustees should have management and dispositive powers over the property. They may charge the widow a market rent or indeed sell the property. They will also have express power to allow the life tenants of the property to occupy the building rent free. They can in fact be expected to choose the latter course.

The children may and usually will choose not to exercise their right to occupy the property. In that case it may be that the trustees' proper course is to charge the widow an occupation rent. Instead of doing this, they will seek an indemnity from the children for any possible claim for breach of trust. (If the children are not inclined to accept this, the trustees might consider revoking the children's interest and reverting the property to the widow. This may obviate the tax savings, but should not be disasterous for IHT; see the Inheritance Tax (Double Charges Relief) Regulations 1987.)

Disadvantages of the Recommended Will Trust Form

If all goes well the recommended form of will trust will avoid the IHT charge in respect of the property, without prejudicing the capital gains tax relief or (to any real extent) the widow's security in her home. There are a number of ways in which a substantial IHT charge may arise.

Widow fails to survive the testator

To achieve the full IHT advantage the widow must survive her husband by seven years. If both die at the same time, or if the widow predeceases her husband, there is no tax saving.

Alternatively, if the wife owns the property, her husband must survive her by the seven years.

Change in Law

The key to the success of the proposal is that the termination of the widows interest in possession at stage (2) is a potentially exempt transfer, and is not a “disposal by way of gift.” That has been the law since the Finance Act 1986.

The exemption for potentially exempt transfers may of course be withdrawn by a future government. Such a proposal has, inter alia, been advocated by the recent reports of the Fabian Society (“The Reform of Direct Taxation”, 1990) and the Institute of Fiscal Studies (“Death and Taxes”, 1989).

Any administration may introduce legislation to deem the termination of an interest in possession to be a “disposal by way of gift”. This was the estate duty position, at least since 1969: see s. 2(1)(b)(ii) FA 1894 as amended.

A taxpayer adopting this scheme must hope for calm weather in a turbulent fiscal climate. The proposal is no substitute for schemes based on lifetime giving, but should rather be viewed as a fall-back position for the individual who is not prepared to contemplate a lifetime gift.

Variant arrangements

The scheme is of course flexible and details may be altered to suit particular circumstances, such as where the testator wishes to benefit infants.

Deeds of Variation

Where a will does not take the most tax efficient form, (typically, where the entire estate is lefgt to the surviving spouse) arrangements of this kind may generally be put into effect after a death, by means of a deed of variation. The threat to introduce new anti avoidance provisions relating to Deeds of Variation in the FA 1990 has not materialised; it can be seen as a graceful means of withdrawing a politically contentious proposal.

THE FAMILY HOME AND THE USE OF NIL RATE BAND.

The most basic form of IHT planning, since the inception of CTT in 1984, has been the use of the nil rate band on the first death of a married couple. At current tax rates, a gift of an entire estate to the surviving spouse may give rise to additional tax of some 51,000 on the death of the survivor. The actual tax liability may be much greater.

It is easy for a wealthy testator to use the nil rate band. If the surviving spouse needs all the assets of the estate, then the testator may create a nil rate discretionary trust of investments. The spouse may in practice be the principal beneficiary of the trust during her lifetime.

However, it happens not infrequently that the only valuable asset in the estate of husband and wife is the matrimonial home, whose value is in excess of the nil rate band. In these circumstances the only asset available to use the nil rate band is the home itself. Planning is then more difficult.

Absolute Gift of share in the property to Children

One possibility is to give to the children of the marriage a share in the property absolutely. The residue may then be given to the spouse absolutely or for an interest in possession.

IHT considerations.

The gift to the children will be intended to use up the nil rate band and the size of the share should be one whose value is equal to the testator's available nil rate band.

Obviously the size of the share will depend on a property valuation, the circumstances of the testator, and the form of the tax system at the time of his death. The desired result can be achieved easily by use of a formula in a will; or by means of a deed of variation after death. It is probably better practice to draft the will properly and not to have to rely on deeds of variation.

On the death of the spouse, her share in the property will be taxed as part of her estate. She will be taxed on the value of her share.

CGT considerations

From a CGT viewpoint a gift to children may be less favourable than a gift to the spouse. If the property is sold during the widow's lifetime, then the widow will receive the benefit of the CGT relief for her residence on her share only. The children are potentially subject to CGT on gains accruing from their share. This may matter little if the value of the property is modest, especially if the gains are shared between a number of individuals who can use their annual allowance and lower rates of tax. The effective rate of CGT may then be nil or very low. In other circumstances the rate may of course be 40%.

Practical Considerations

On the first death there is twofold scope for conflict.

First the widow may be in a position to make a claim under the Inheritance (Provision for Family and Dependants) Act 1975, on the grounds that she has not received reasonable provision under the will.

Secondly, the property may be itself a source of dispute. The widow will not have an absolute security of tenure. She will only own a share in the property jointly with her children. She will then find that her children have an equal right to occupy the property, or to require her to pay an occupational rent, or they may even

seek to have the property sold; not to mention the possibility of their insolvency.

The gift of a share absolutely to children is therefore only advisable in cases where the family is both an absolutely united one and financially secure. In other cases, more sophisticated arrangements involving trusts will be preferable.

The will may provide that the house is not to be sold without the consent of the surviving spouse. This gives some (but not complete) security to the surviving spouse.

Gift by will to Settlement: Interest in Possession for Children

A testator may leave his home to a settlement under which his children have an interest in possession in an appropriate share. This is the settled equivalent of a gift of a share to the children absolutely; The practical effect is broadly the same, but it should be noted that: -

(i) If the trustees of the settlement are given appropriate powers, the position of the children is substantially weaker; and the security of the widow greatly increased.

(ii) On the sale of the property the rate of CGT will be 25%; arguably there may be no CGT at all; see the discussion above relating to will trusts for the spouse.

Unpaid pecuniary legacy to Discretionary trusts

Another means of using the nil rate band is for the testator to bequeath a pecuniary legacy of an amount equal to the nil rate band to a discretionary trust. On his death, this legacy may remain unpaid, as a charge on the property which the spouse inherits from the testator. (The Will must provide the express powers needed to authorise this.) The intention is that on the death of the testator's widow, that charge should be deductible in calculating the value of her estate.

This course had advantages and disadvantages. In its favour, it is clear that the property (which will become vested in the surviving spouse) may enjoy the full private residence relief from CGT, notwithstanding the charge: see s. 23 CGTA 1979. Against this, the scheme is fairly complex to carry out; in certain circumstances s. 5 IHTA 1984, or s. 103 FA 1986 may operate to deny the spouse's estate the benefit of the deduction in respect of the charge. Unless very complicated steps are taken, inflation will gradually erode its true value. On balance, the preferred course is to give shares in the property to a settlement for the children.

Use of family home for Equalisation of Estates of husband and wife

It will sometimes be advantageous to give the spouse a share in the matrimonial home, or an interest in possession in a share under a settlement, up to the value of the nil rate band. This can secure the IHT advantage of use of her nil rate band, without affecting the husband's own position or conferring on her any valuable rights in the event of a divorce.

The gift of a share of the property to the wife, apart from the IHT saving, is largely tax neutral. The gift itself is generally an exempt transfer for IHT purposes: s.18 IHTA 1984. The CGT exemption remains available if the property is the main private residence of husband and wife.

Provision to benefit family and Charity

A testator without direct family may wish his home to pass to his widow for her life, and after her death to charity. That is easy to achieve by an appropriate trust. The gift to the trust on the testator's death is exempt by virtue of the spouse exemption; there is no tax charge on the spouse's death if the charity then becomes absolutely entitled to the property: s.23 IHTA 1984.

It may be is desired that the charity should maintain the property during the life of the surviving spouse (or indeed during the life of the present owner of the property) in return for receiving the property on the death of the survivor. Careful drafting is needed to ensure that the Charity does not acquire an equitable interest in the property for a consideration, which would lose the charity tax exemption. See s. 56(3)(b) IHTA 1984.

PART TWO: LIFETIME PLANNING

Tax saving through wills, when all is said and done, remains at best precarious. Where the testator has no spouse, there is very little scope for tax planning at all. The key to effective IHT saving is lifetime planning.

Gift of Share to Children

Begin with a seemingly simple option: an absolute lifetime gifts of a share in the property. It may be advantageous for a parent to give a share in his home to his children, if the children live in the same

property as the parent and do not intend to leave it. The tax and non tax implications of the gift require careful consideration.

CGT Considerations

The CGT position is simple and satisfactory. The gift to the child will not give rise to a chargeable gain since the property will qualify for private residence relief. CGT relief on a later sale of the property remains available if the property will be the child's main private residence as well as that of the parent.

IHT considerations

The gift itself is a potentially exempt transfer, and does offer scope for tax saving on the death of the donor if he survives the requisite period.

S.102 FA 1986 (gifts with reservation) is the immediate consideration. If s.102 applies the gifted property is deemed to form part of the donor's estate on his death, leading to the IHT charge on the donor's death that it was hoped to avoid. It is essential to prevent this section from applying in order to retain the IHT advantages of the gift.

The section applies where

“an individual disposes of any property by way of gift and either -

(a) possession and enjoyment of the property is not bona fide assumed by the donee ... ; or

(b) at any time ... the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise .”

The effect of these words in the present context raises a number of questions.

Condition (a) is relatively easy. To avoid the section, the donee must “assume possession and enjoyment” of the property. If he resides in the property of which he is given a share then he satisfies this condition. Otherwise it is thought that he does not do so. For this reason a parent should not generally give a share of his property to a child (or other person) who does not reside there.

Condition (b) is more difficult. This condition contains two limbs. First, the property must be enjoyed to the (virtual) exclusion of the donor. If the donor gives away all his interest in the property, but continues to live there, then this condition is infringed (see Chick v Commissioner of Stamp Duties [1958] AC 435, overruling by implication the unpersuasive reasoning in AG v Seccombe [1911] 2 KB 688).

If, say, a mother gives her daughter a share in the property, and continues to live in the property after his gift, the position is quite different. As she holds an interest in the property, she has the right to live there by virtue of that interest. So merely by continuing to live in the property she does not necessarily enjoy any benefit from the property that she has given away.

The second limb of condition (b) of s.102 FA 1986 (gifts with reservation) must also be borne in mind. This effectively forbids the donor (in the example, the mother) from enjoying benefit from the property which she has given away "by contract or otherwise" (other than benefits which are de minimis). Care must therefore be taken to avoid any indirect benefits.

An obvious reservation of benefit might occur if the donee pays more than her fair share of the expenses of running the property (costs of maintenance, insurance etc). It does not matter if the donor (the parent, in our example) pays more than her fair share; but the donee (the child) should never do so.

It is possible to provide that the property (of which the daughter acquires a share) should not be sold without the consent of the mother. It is considered that this provision would amount to a reservation of benefit, and such a term should not be included in the conveyance to the daughter. (Some commentators believe that the donor's right to prevent a sale might be considered a retained right, over which no benefit is reserved. But the true analysis, it is feared, is that the restriction on sale is a distinct right which did not exist before the transfer and cannot be defended by analogy with such cases as Munro v Commissioner of Stamp Duties [1934] AC 61; see Nichols v IRC [1975] STC 278.)

If the donee ceases permanently to reside in the property during (in our example) her mother's lifetime, then a reservation of benefit problem arises. Once the daughter leaves the property, an indirect benefit accrues to the mother - namely, the benefit of sole occupation of the property. For this reason the strategy of giving a share in the property is only appropriate when the child's residence in that property is likely to last as long as the mother lives there.

Suppose the unexpected does happen and the daughter leaves. The tax consequences may not be disastrous. There are at least three possibilities:-

(1) Payment of an occupation rent by the mother to the daughter. This obviates the reservation of benefit problem: see FA 1986 sch 20 para 6(1)(a). The solution is less than satisfactory, since the rent will be taxable in the daughter's hands.

(2) The FA 1986 sch 20 para 6(1)(b) may sometimes, but will not usually offer any defence. The principal difficulty here is that, to satisfy the statutory requirements, there must be a change in the circumstances of the donor, and not of the donee.

(3) It may be possible to give the mother an interest in possession in the daughter's share. This may obviate the reservation of benefit difficulties, without necessarily an IHT or CGT downside.

Clients should be advised to seek further advice if the daughter ever proposes to cease to reside in the property.

How Great a Share?

How large a share in the property may be given to the child? It has been suggested that the widow could safely give, say, a nine tenths share to her daughter. For the widow's continuing occupation of the property will still be attributable to her retained share. In the

case of a gift of a disproportionate share, however, the Revenue might argue that the daughter's failure to seek a sale of the property (or an occupational rent) constitutes an indirect benefit by associated operations. This argument overlooks the very real problem that the daughter would face in litigation on this point with her mother, under current law.

Nevertheless a cautious view is to be preferred. If the mother is sharing the house with a single daughter she should only give a one half share to her; if she shares with two children, she may safely give a one third share to each, retaining a one third share herself; and so on.

Conclusion

In the situation where, say, an elderly widow lives in a single property with her daughter, the mother may give her daughter a half share in the property absolutely without necessarily infringing the gift with reservation rules. A gift of this kind is in fact a simple and comparatively painless form of tax planning.

If the widow does not wish her daughter to enjoy the full rights attaching to ownership of a half share in the property then a gift to a settlement may be considered. The settlement may even provide that the property should revert to the mother should the daughter

predecease her; but careful drafting would be necessary to avoid the gift with reservation provisions.

Gift via Settlement: Recommended Lifetime Planning

Adult children do not generally live in the same property as their parents, and cases of a simple gift of a share in the property to the children will accordingly be rare. Other steps must then be taken if it is desired to make a gift without infringing the Reservation of Benefit rules. The most commonly discussed strategy is the gift of a freehold reversion, considered in full below.

Circumstances often permit more attractive arrangements which are as follows:

(1) The owner of a property transfers it to a settlement under which:

(a) The settlor's spouse initially has an interest in possession (the trustees being directed to pay trust income to her as it arises).

(b) The trustees are given a wide power of appointment over the trust fund in favour of a class of beneficiaries which includes the settlor himself as well as his spouse.

(2) After some time has elapsed the trustees should consider revoking the spouse's interest in possession as to nine tenths of the income, and appointing that income on trust for the settlor's children. The spouse remains entitled to the remaining one tenth of the trust income.

(3) The husband and wife continue to live in the property with their children's express consent. It is advisable (though not essential) for the settlor to deposit with the trustees a letter of wishes explaining how he would like the property to be applied after his death.

The scheme is not dissimilar from the recommended form of will trusts discussed above; much of the discussion is relevant here as there.

IHT implications

The original gift to the settlement is not generally a chargeable transfer; the spouse exemption will apply.

The partial termination of the spouse's interest is a potentially exempt transfer, exempt from IHT if she survives seven years.

Reservation of Benefits

Under this scheme the donor makes a gift of property over which he continues to enjoy benefits. Nevertheless s.102 FA 1986 (gifts with reservation) does not apply since s.102(5)(a) is in point:

"this section [s.102 FA 1986] does not apply if ... the disposal of property by way of gift is an exempt transfer by virtue of ... (a) s. 18 [IHTA 1984] (transfers between spouses)."

The gift to the settlement is wholly exempt by virtue of s.18, so s. 102 FA 1986 is excluded.

The scheme exploits a drafting error in s.102 which may one day be corrected, but retrospective legislation is most unlikely.

One should consider two arguments which may be open to the Revenue if they wish to dispute this scheme, which does to a large extent render the anti-avoidance provisions impotent.

First, could it be said that the transfer to the settlement is not exempt “by virtue of s.18;” but is exempt by virtue of a combination of s.18 and s.49 (which provides that a person beneficially entitled to an interest in possession in settled property shall be treated for the purposes of the IHTA as beneficially entitled to the property itself). The argument is thought to be untenable. It amounts to reading into s.49 an exception which is not there.

It should be noted, incidentally, that s.80 IHTA 1984 is not in point; that section only applies for limited purposes.

A more attractive argument could be founded on Furniss v Dawson 55 TC 324. If the creation of the spouse’s interest in possession at stage (1) and its partial revocation at stage (2) are “pre-ordained” transactions, then IHT could be charged on the basis that the gift was made directly to the children. The settlor must ensure that he is in a position to prove that the two steps are not pre-ordained. That, of course, would be a complete defence to a Furniss v Dawson attack - see Craven v White [1988] STC 476. It is desirable that there be one or more professional trustees who will be able to testify that they have not made a final decision to carry out stage (2) at the time of stage (1). Preferably stage (2) should not take place until after the Budget after the gift to the settlement. The decision whether or not to make an appointment would be reviewed in the light of the Budget, and in view of the

uncertainties so raised there could be no question of pre-ordination.

The principal risk involved in this course is that the law may be so amended in the Budget that the termination of the interest in possession becomes impractical, perhaps by repeal or amendment of s.102(5)(a) FA 1986 or s. 3A IHTA 1984. That is a necessary risk if the scheme is to stand up to challenge. Indeed those of a very cautious frame of mind may prefer to wait two full years. If the law is changed, however, it will almost certainly be possible to reappoint the property back to the settlor absolutely. Nothing will have been lost except a certain amount of time and trouble.

Arrangements of this kind require a longer timescale to put into effect if the property is not held by one spouse absolutely, but held jointly by both spouses.

CGT implications

The transfer to the settlement will not normally give rise to a chargeable gain since the usual CGT residence relief will apply.

For the reasons set out above in discussing the recommended will trust arrangements, it is thought that the CGT residence exemption may continue to be available on a later sale of the property.

Security of tenure

The position is broadly the same as pertains under the recommended will trust arrangements, discussed above.

Gift of Freehold Reversion

The true nature of IHT - Estate Duty by another name - is disclosed in this scheme, a classic form of estate duty avoidance (see, for instance, [1962] British Tax Review page 1) or the 4th Edition of Potter and Monroe's Tax Planning (1963)).

In outline the scheme works as follows:

(1) An individual transfers his home to a nominee who holds the property on trust for himself absolutely.

(2) At the direction of the individual the nominee grants the individual a lease for a period of years fixed to approximately equal the individual's life expectancy.

(3) At the direction of the individual, the nominee transfers the reversion to the property subject to the lease ("the freehold reversion") to trustees to hold on trusts of an appropriately drafted settlement.

(4) The individual will make appropriate provision in his will concerning the lease which he retains; he may also leave a letter of wishes for the benefit of the trustees of the settlement.

(5) The individual continues to live in the property by virtue of his leasehold interest.

Steps (1) and (2) are fiscally neutral. They are essentially matters of conveyancing, necessary in order to carry out step (3) - the gift of the freehold reversion.

The individual will enjoy complete security of tenure for the duration of the lease which he retains.

The IHT Position

The gift of the freehold reversion at stage (3) will be a potentially exempt transfer. The value transferred will be small, in comparison to the whole property: the long lease (retained in the donor's estate) will be of substantial value.

By the time of the individual's death, some years later, the position will have altered. The asset in the individual's estate, the lease, will be of little value. IHT will only be charged on that lower value. The reversion will be valuable, since it should only be subject to a short lease. The reversion, however, is not in the donor's estate and is not subject to tax on his death.

Gifts with Reservation

Commentators generally accept that the gifts with reservation rules do not apply.

It may be helpful to set out the statutory provision again. By s.102 FA 1986, property may become "subject to a reservation" if

"(a) possession and enjoyment of the property is not bona fide assumed by the donee ... ; or

(b) ... the property is not enjoyed to the entire exclusion, or virtually to the entire exclusion, of the donor and of any benefit to him by contract or otherwise."

Condition (a) - that the donee assumes possession and enjoyment - is easily satisfied. The donee will receive the rent under the lease, and this must constitute the "assumption of possession and enjoyment".

The first limb of condition (b) - that the donor is excluded from the property he has given away - also raises no difficulty. The property given away is the freehold reversion. The donor will enjoy no benefit from the reversion. The gift with reservation rules must be applied strictly to the property given away and benefits from retained property are irrelevant. This has been emphasised in Australian and English estate duty cases; See Munro v Commissioner of Stamp Duties [1934] AC 61; St Aubyn v AG [1952] AC 15.

In informal correspondence the Revenue have accepted this general principle of the operation of the reservation of benefit rules; but with the significant qualification that there will be a reservation of benefit unless the creation of the lease and the gift

of the reversion are "independent transactions." The Revenue take the view that the two transactions will not usually be "independent" if they are carried out contemporaneously. Their view, if correct, would nullify the scope for tax saving. For if the reservation of benefit provisions apply, then the freehold reversion must be deemed to form part of the estate of the donor on his death (see s.102(3) FA 1986) and this leads to the IHT charge which it was hoped to avoid. Indeed the position is worse than if nothing had been done, in view of the CGT consequences of the scheme.

The Revenue's view is based on the following passage in the judgment of the Court of Appeal delivered by Goff J in Nichols v IRC [1975] STC 278:

"... we think that a grant of the fee simple, subject to and with the benefit of a lease back, where such grant is made by a person who owns the whole freehold free from any lease, is a grant of the whole fee simple with something reserved out of it, and not a gift of a partial interest leaving something in the hands of the grantor which he has not given. It is not like a reversion or remainder expectant on a prior interest. ... Of course, where, as in the Munro case, the lease ... arises under a prior independent transaction, no question can arise because the donor then gives all that he has, but where it is a condition of the gift that a lease back shall be created, we think that must, on a true analysis, be a reservation of a benefit out of the gift and not something not given at all."

(Emphasis added.)

It is submitted that Goff J is contrasting two situations:

(i) a grant of a fee simple subject to a lease back; and

(ii) a gift of a freehold reversion where the lease has been created first. That is, the lease is created by a separate (“independent”) transaction from the disposal by way of gift.

The passage in context cannot be taken to mean that the reservation of benefit rules apply merely because an asset has been split into two new assets with a view to giving one of the new assets away. Indeed, in St Aubyn it is manifestly clear that an asset was created for this purpose yet the House of Lords held that the gift with reservation rules did not apply.

The second limb of condition (b) in s.102 FA 1986 imposes the requirement that the donor should not enjoy any incidental benefits from the property he has given away. This need not cause problems.

Associated Operations

The associated operations rule is one of the more obscure provisions in the IHTA 1984. (Not by any means the most obscure; contrast s. 38(3)(4) “of byzantine complexity” per Knox

J in **Russell v IRC** [1988] STC 195; or s. 29A IHTA 1984, fortunately not of general significance.)

Section 268(3) IHTA 1984 provides:

"Where a transfer of value is made by associated operations carried out at different times it shall be treated as made at the time of the last of them; but where any one or more of the earlier operations also constitute a transfer of value made by the same transferor, the value transferred by the earlier operations shall be treated as reducing the value transferred by all the operations taken together."

In the past the Revenue have not made much use of this section, though they have had success with the concept of associated operations in other contexts: see Macpherson v IRC [1988] STC 362.

Is it possible to argue that this rule affects gifts of a freehold reversion?

The Revenue's argument would run as follows:

(1) The scheme involves two significant operations: the gift of the freehold reversion and the disposition of the lease on the donor's death. The two operations are "associated".

(2) At the time of the testator's death there will be a disposition effected by associated operations.

(3) The value transferred by this disposition is the value of the unencumbered freehold of the property at the time of death.

Certainly the disposition of the lease under the will or intestacy of the tenant will be an "operation" for the purposes of the associated operation rules. See Bambridge v IRC 36 TC 313. The gift of the reversion is also an "operation". (It should be noted that if the tenant outlives the lease, then there is but one "operation". The Revenue's argument does not run. This does lead to anomalies, though on any view anomalies must arise.)

It is considered that the two operations are not "associated". S.268 (1)(b) is probably not in point. The gift of the reversion is not "effected with reference to" the disposition on death nor "with a view to" enabling that disposition to be effected, nor with a view to facilitating its being effected. Para (a) of s.268(1) is not in point either. Operations are only associated if they fall within (a) or (b) of s.268(1).

Even if the operations were "associated", the Revenue argument may fall into difficulties at stage (2). If, for sake of argument, the individual gave his lease to the trustees who held the freehold reversion, so that the lease merged into the reversion, then one could identify a disposition effected by associated operations. The "disposition" would be a gift of the entire interest in the fee simple. But if the lease is given to another person so that it does not merge with the freehold reversion, then there is no single disposition effected by associated operations. There are two separate dispositions which cannot be integrated. In those circumstances it is considered that s.268(3) cannot apply.

The conclusion is this: the lease should <u>not</u> pass to the freehold reversioner on the death of the individual. It should be given either to another individual or (preferably) to separate trustees of a separately constituted trust.

Form of Lease

The form of the lease may now be considered in more detail.

Duration

The lease gives the donor security in his home. Its length must be fixed at the outset (see below) but should slightly exceed the individual's life expectancy. A lease for life is generally ruled out because of s. 43(3) IHTA 1984.

Individual circumstances must of course be considered; and it is better to err on the side of caution. The term of the lease must exceed seven years in any event.

There is no need for a market rent to be payable under the lease. (S.268(2) IHTA 1984, and sch 20 para 6(1)(a) FA 1986 do offer certain exemptions when market rent is paid, but the proposals now under consideration do not rely on either of these.) A modest rent should be paid, perhaps 100 per annum. The rent should be paid each year. If the freehold reversion is held by trustees they should in turn pay to the beneficiaries the rent, (if necessary, after payment of trustees' expenses.) Receipts should be kept on record.

This procedure needs to be carried out scrupulously to prove that the donee has assumed "possession and enjoyment" of the reversion, and so satisfies condition (a) of s.102(1) FA 1986. The rent will of course be subject to UK tax; and if paid direct to a non-resident person, tax may have to be deducted at source in accordance with s. 43 TA 1988.

The lease must be drafted so as to impose no obligations of any kind on the landlord. A seemingly innocuous covenant to maintain the property may amount to a reservation of benefit under the second limb of s. 102(1)(b) FA 1986. See Nichols v IRC [1975] STC 278.

The Landlord and Tenant Act 1985 normally imposes duties on the landlord regarding maintenance of the property. Fortunately these can be excluded.

It is suggested, principally for reasons of convenience, that the tenant should be responsible for maintenance and insurance of the property. (This would, incidentally, slightly reduce the value of the individual's lease if it needs to be valued on his death. S.5(5) IHTA 1984 is not in point, since one is not deducting liabilities from an estate, but valuing an onerous lease.)

To Whom Should the Freehold Reversion be Given?

The freehold reversion could be given to an individual, perhaps the child of the owner, absolutely. A gift to a settlement offers practical and fiscal advantages and will generally be preferable. The settlor should be excluded from the settlement. Where the sums involved justify the expense, a gift to a settlement which (for CGT purposes) is not UK resident may be attractive in view of the CGT problems which may arise on a sale of the property.

It is suggested that the settlement should be drafted so that the settlor’s children have interests in possession in the property subject to a flexible overriding power of appointment. This makes for an easier - and so cheaper - administration as compared to discretionary or accumulation and maintenance settlements. The trustees, wherever resident, will wish to ensure that their fees will be met. It is possible, though not tax efficient, to pay trustees fees out of the rents payable by the tenant.

Possible Problems under Gift of Freehold Reversion

Donor Survives Lease

What will be the position if the individual who has given away a freehold reversion is still living when his lease expires? First, of course, he will have no security of tenure in his own property. The individual might possibly take out term insurance to provide him with a sum of money to find new accommodation in this eventuality. Insurance would be cheaply obtainable. Otherwise the individual would have to rely on his other resources, or on his children to allow him to continue to reside there.

What would be the tax position if he continues to occupy the property after the expiry of his lease? The position should not be

irredemable; among other options, the payment of market rent should solve the IHT problem: Finance Act 1986 Schedule 20 Paragraph 6(1)(a). At the outset, the most that can be said is that the position should be reviewed as the lease draws to a close, if the donor is still living.

Problems on Sale of the Property.

Grave difficulties may arise if the donor wished to move home and needed to sell his present home to raise funds for that purpose. First, of course, he will only own the lease and not the reversion. Even assuming that the trustees will sell the reversion simultaneously, the individual will only be entitled to receive a proportion of the total purchase price.

The difficulties of selling the property are such that a gift of a freehold reversion is only advisable where the donor has the firm intention to remain in his property for the rest of his life.

Tax Problems on sale of the lease

The sale of the lease gives rise to tax difficulties. There is no CGT charge, as the usual relief for the main private residence will be available. But an assignment of the lease on sale may give rise to

an income charge under s.35(2) TA 1988. This is on the basis that the grantor of the lease could have required an additional sum by way of premium “on the assumption that negotiations for the lease were at arm’s length”. One could argue with some force that this section cannot apply to a grant to a nominee, since no additional sum by way of premium could be required. That argument would render the anti-avoidance provisions ineffective, and, it is considered, pays insufficient regard to the “arm’s length” requirement.

A suggested solution is that the tenant should surrender the lease to the landlord for a consideration. The landlord may then sell the entire freehold interest. A surrender is not an “assignment” in the strict conveyancing sense. No tax charge under s.35(2) would arise. The distinction between “assignment” and “surrender” might be thought to be a mere technicality but nevertheless it is well established; moreover a surrender is outside the mischief of s. 35(2).

However, the surrender of the lease may give rise to difficulties under s.776 TA 1988 (transactions in land). The trustees - if they are not trading in land by buying in the lease and selling the freehold - have acquired land with the sole or main object of realising a gain on sale. An argument that a surrender is not an “acquisition” is distinctly tenuous in view of s.776(4) which provides effectively that substance is to prevail over form.

A possible solution to this problem, if circumstances permit, is that the individual should surrender his lease to the landlord for no consideration. There is then a reasonably sound defence to s.776, that the trustees do not acquire "with the sole or main object of realising a gain": see McClelland v Taxation Commissioner [1971] 1 WLR 191 (PC). The individual must then finance the purchase of the property out of his own resources, an unsatisfactory result. The chargeable gain accruing on the sale of the Reversion is also increased.

Similar problems arise if the donor dies at the time when the lease has a number of years left to run, and the property is to be sold at that time. The best course may be that the person who takes the lease under the testator's will should surrender it to the trustees who hold the freehold reversion for nominal consideration. This should avoid both income tax and s.776 problems. Such a surrender, if made by an individual, would make him a "settlor" of the settlement for CGT and IT purposes with undesirable consequences. The lease should therefore pass under the will to trustees of a separate settlement ("the lease settlement"). The trustees of the lease settlement will have express power to proceed as desired. No living individual provides funds for the settlement, and the settlement provisions are not brought into operation. The lease settlement should not be in discretionary form; s.144 IHTA 1984 may then apply. An interest in possession settlement for the benefit of adult children would be best. S. 52(3) IHTA 1984 (depreciatory transactions) should be borne in mind but need not usually cause difficulties.

Tax Problems on Sale of Reversion

If the trustees who hold the freehold reversion in the property sell it, then a substantial chargeable gain will arise. CGT relief for the main private residence will not be available.

The cost of acquisition of the reversion for CGT purposes will be its market value at the time of the gift to the settlement: s.29A CGTA 1979. That will be low. The sale will then give rise to a CGT charge, if the settlement is UK resident, on an amount which may substantially equal the value of the property.

The effect of the gift of the reversion may therefore be to convert an IHT charge to a CGT charge. That alone is a worthwhile transmutation. The effective rate of CGT is 25% (contrast IHT, 40%); expenses of disposal are deductible for CGT (not so for IHT); payment of CGT is deferred until up to 18 months after a sale has been made.

There is also much scope for mitigation of the CGT charge.

Gift of Freehold Reversion: Conclusions

The gift of a reversion - if carefully carried out - will generally save IHT; but in many ways it is rather unsatisfactory. Problems arise if the individual dies early (leaving a valuable lease in his estate); or if he dies late, surviving his lease; CGT is sometimes a serious drawback; there are severe difficulties if the property is to be sold during the individual's lifetime; and difficulties may arise on a sale after his death.

In addition the scheme is complex to execute, and may lead to not inconsiderable professional expense. In particular, the Revenue have challanged such schemes as have come to fruition in the last four years. No doubt each taxpayer will hope that his own estate will not bear the costs of a test case.

The IHT advantages will generally outweigh all disadvantages, however, as long as the donor does not intend to move home. Nevertheless if any other tax saving alternative is available, that should generally be considered preferable to the gift of a freehold reversion, which is a last resort.

Reversionary Lease

A variant to the above arrangements for a gift of freehold reversion is sometimes propounded.

Under English law it is possible to grant a lease which commences at a future date. This is known as a reversionary lease.

It has been ingeniously suggested that an individual might grant, for nominal consideration, a long (say 999 year) lease to his children or to trustees of an appropriate settlement. The lease would be a reversionary lease, commencing, say, 21 years after the date of the grant. The donor may therefore continue to live in the property until the lease commenced: but thereafter he would only have a (worthless) freehold reversion.

This proposal avoids many of the tax problems which attached to the more cumbersome scheme set out above. First and foremost, there is only one grant of a lease, and it is harder for the Revenue to raise the (in any case highly doubtful) doctrine of "prior independent transaction." Second, on the sale of the property, no income tax problems arise under s.35(2) TA 1988.

Unfortunately the grant of a reversionary lese brings with it an entirely new problem. Does the donee - that is, the tenant under the reversionary lease - "assume possession and enjoyment " of the reversionary lease? If not, the lease is property subject to a reservation, by virtue of condition (a) of s.102(1) FA 1986, and the IHT saving is lost.

On one view, the donee cannot be said to have assumed possession or enjoyment: he does not receive any enjoyment from the property at all until the lease commences. On another view the donee does satisfy the condition. Although he receives no immediate tangible benefit from the property, it is vested in him. He may sell it, mortgage or charge it. No other "enjoyment" is possible by the nature of the property, and nothing further could be required.

Which view is correct? Neither is wholly satisfactory. The former leads to the unattractive consequence that IHT penalises all gifts of reversionary interests. The latter effectively deprives condition (a) of s.102 of all meaning.

A similar question once arose in the estate duty case of Re Harmsworth [1967] Ch 826. Lord Denning took the former view and Harman LJ took the latter view. Salmon LJ took a line which would have delighted the late Sir A.P. Herbert, agreeing with both judgements.

It is submitted that the view of Harman LJ is to be preferred; and Perpetual Executors & Trustees Association of Australia Ltd v The Commissioner of Taxes of the Commonwealth of Australia [1954] AC 114 tends to support this conclusion.

While the answer to this question remains unclear, the use of a reversionary lease is a course which substitutes one set of risks for another. On balance, the conventional route is preferred. If a reversionary lease has been granted, the best course may be to sell it for consideration, or charge it for some debt. The sale or charge will, it is thought, constitute the assumption of "enjoyment". That disposes of the IHT difficulties at least if the donor survives seven years after the sale.

Homes Held in Settlement

A full discussion of the position where a home is already held in a settlement is beyond the scope of this article.

Take briefly the common situation where the property is held in a will trust constituted by the testator for his widow. An inter vivos settlement created at an earlier date might also be a suitable source of funds for the purchase of a home. In the usual situation the occupier of the trust property will be the life tenant under the settlement. While this is fine for CGT purposes (the property will qualify for CGT relief), the challenge is to avoid the IHT charge on the death of the life tenant. What can be done?

Many of the strategies discussed above in relation to an individual's main private residence can be adopted to the situation of a settlement. The two most common arrangements will be the

use of an overriding power of appointment and the creation of a freehold reversion.

If the trustees have a wide overriding power of appointment then it is possible to carry out a variant of the scheme discussed above. The trustees exercise their power of appointment so that nine tenths of the life tenant's interest in possession is appointed to younger, adult beneficiaries. In this way, if the life tenant's survives the seven year period, the IHT saving can be achieved, without, it is thought, imperilling the CGT relief.

If the trustees do not have a wide overriding power of appointment, a similar result may be obtainable by exercise of the power of advancement conferred by s.32 Trustee Act 1925. It is considered that the life tenant's consent to the trustees' exercise of this power does not constitute a "disposal by way of gift" so that s. 102 FA 1986 cannot apply.

If there is no overriding power of appointment, as will often be the case in an unsophisticated will trust, the trustees may carve out a long lease from the property held on trust in which the life tenant resides. The life tenant may then make a gift of her equitable interest in the freehold reversion. This is a variant of the "gift of freehold reversion" scheme discussed at length above. It may be arguable that CGT relief remains available on a sale of the property.

CONCLUSION

There is enormous scope for tax planning in relation to the family home. This should not be thought extraordinary or even surprising. English law offers such a rich variety of means of dealing with property, that it is open to doubt whether any IHT system - or even a CTT system - could be devised under which there was not substantial scope for tax saving.

Here is information on how to order *Drafting Trusts and Will Trusts* and other books by James Kessler QC.

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