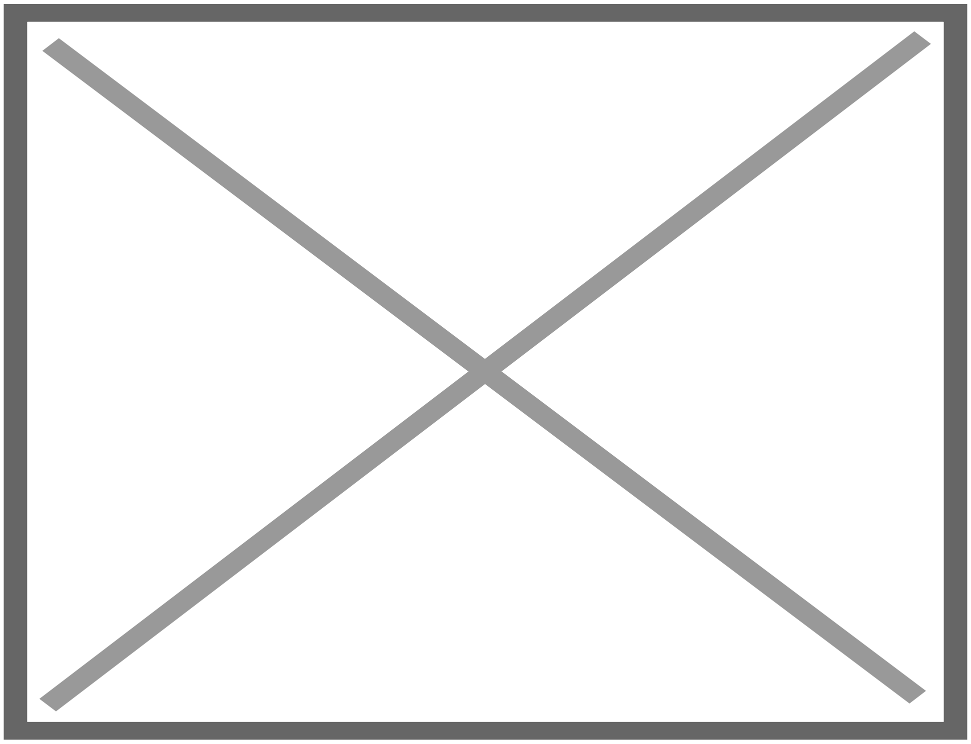
A complicated gift

Inheritance tax and trusts



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Emma Chamberlain considers the common problems caused by reservation of benefit, and a change of approach by HMRC

Key Points

What is the issue?

Under Finance Act 1986 s 102, when there is a reservation of benefit in gifted property at the date of death, for inheritance tax purposes that property is treated as property to which the donor was beneficially entitled at his death and is taxable under Inheritance Tax Act (IHTA) 1984 s 4.

What does it mean for me?

Where the reservation of benefit ceases at any time during the donor's life, he is treated as making a potentially exempt transfer at that time. A deemed transfer becomes chargeable only on the donor's death within seven years of the reservation of benefit ceasing.

What can I take away?

If the settlor wants to avoid a reservation of benefit problem, he will need to decide whether the trust terms should be changed to give the surviving spouse the property on death or to act now and be excluded from the trust and hope to survive seven years.

Under Finance Act 1986 s 102, when there is a reservation of benefit in gifted property at the date of death, for inheritance tax purposes that property is treated by sub-section (3) as property to which the donor was beneficially entitled at his death. This means it is taxable under Inheritance Tax Act (IHTA) 1984 s 4. Where the reservation ceases at any time during the donor's life, he is treated by sub-section 102(4) as making a potentially exempt transfer at that time. Like an ordinary potentially exempt transfer, the deemed one under sub-section (4) becomes chargeable only on the donor's death within seven years of the reservation of benefit ceasing. Hence under both sections, it is not until the donor's death that any tax can become payable under the gift of reservation rules.

This method of taxing reserved gifts has a number of implications:

1. If the donor reserves a benefit in property at the time of his death so that s 102(3) is in point, that property is brought back into the donor's estate for the purposes of inheritance tax under IHTA 1984 s 4 but does not form part of the donor's estate for purposes such as capital gains tax. The normal capital gains tax death uplift is not available.

2. Even in the inheritance tax context, the gifted property remains comprised in the donee's estate. Hence, if the donee dies shortly afterwards there could also be an inheritance tax charge on the donee's death with no possibility of double charges relief.

3. Even if the donor reserves a benefit in a discretionary trust, on lifetime cessation of that reservation this is still a deemed potentially exempt transfer, not a chargeable transfer. No reporting is required unless the donor dies within seven years.

4. Liabilities incurred by the donor in respect of his free estate are not available to reduce the taxable value of the property subject to a reservation. However, liabilities to which such property is subject would, on general principles, appear to be deductible. (This is currently the subject of some debate in relation to home loan schemes.)

5. The liability to pay inheritance tax due on a reservation of benefit at death falls primarily on the donee and only on the personal representatives after a year if the donee has not yet paid it. See IHTA s 204(9). (In relation to reservation of benefit in settled property, the trustees (not the personal representatives) are liable for the inheritance tax; and unless the settled property in question is UK land no liability should fall on the personal representatives (see IHTA 1984 s 204(1)(a)).

6. There is no safe period after which benefits can be taken in gifted property. For example, a gift might have been made in 1987 and the donor is entirely excluded for many years. This will not matter if shortly before his death the donor then receives some benefit.

Example 1: Reservation of benefit

Hugo gives his house to his son in 1997, who lets it out to third parties. Hugo lives abroad for many years but then comes back in 2017 and lives in the house rent free until his death in 2020.

On his death, the house is subject to a reservation of benefit and will therefore be subject to tax. His son is liable to pay the inheritance tax due. The residential nil rate band may be available to reduce inheritance tax if the other conditions are satisfied.

Residential nil rate band

The residential nil rate band for deaths from 29 October 2018 applies only where the donee at the time of the gift is a child or other issue of the deceased. See IHTA 1984 s 8J(6).

Example 2: Residence still subject to loan

Peter effected a home loan scheme in 2003 and has just died (see Tax Adviser, ‘Keeping it in the family’ (March 2021) and ‘New hurdles to overcome’ (April 2021)). The house is still subject to the loan at Peter’s death, and he has had a qualifying interest in possession in the house trust from 2003.

The house passes outright to the children under the terms of the trust, who therefore ‘closely inherit’.

HMRC argues (in the author’s view incorrectly) that Peter has reserved a benefit in the house at the date of his death. HMRC also denies the residential nil rate band as the property did not become comprised in the children’s estate at the time of the original gift. If the loan had been written off prior to death so that (according to HMRC’s analysis) the reservation of benefit had ceased in the house, then the house would be comprised in the donor’s estate but under IHTA 1984 s 49. Residential property relief should then be available if the children take the property outright on Peter’s death (not on continuing trusts). If Peter had died before October 2018, then the residential nil rate band may have been available subject to the other conditions being satisfied.

The scope of s 102(4)

What happens if the reservation of benefit ends inter vivos (as a gift between living people) because the property actually becomes comprised in the donor’s estate in the real world?

Example 3: Potentially exempt transfer?

Chris is a discretionary beneficiary of a trust he established in 2010. He therefore reserves a benefit. In 2021, the property is appointed back to him and the trust ended. He dies in 2022. Is there a deemed potentially exempt transfer under s 102(4) when his reservation of benefit ceases, even though the property is also taxed as part of his free estate? The answer is no.

HMRC notes: ‘We do not regard the deemed potentially exempt transfer by A as having any practical consequence because it would have no value.’ It is difficult to see how s 102(4) can apply at all if the property becomes comprised in the donor’s estate, as he continues to enjoy it so there is no deemed potentially exempt transfer.

Spouse exemption

For some time, there has been debate as to how exemptions such as spouse exemption and charity exemption work in connection with the reservation of benefit provisions. In IHTM 14303 HMRC used to note:

‘The gift with reservation rules are fictitious treatments created only for the purposes of preventing inheritance tax avoidance. They do not affect the actual devolution of the property in real life, so the gifted property does not actually pass on death under the will or intestacy, neither was any gift actually made at the time the reservation ceased.

‘The gifted property passed to the actual donee at the time it was actually transferred. Thus, any exemptions that may be available on death, or that apply to potentially exempt transfers, such as charity exemption or annual exemption, will not apply to the transfer deemed to be made on death, or deemed to be made when the reservation ceases.’

Suppose the donor was the discretionary beneficiary of a settlement and on his death the trust ended in favour of his spouse. Would spouse exemption in these circumstances be available? In principle, it now appears yes. IHTA 1984 s18 provides that 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 transferee spouse. On that basis, if the settled property subject to a reservation of benefit on the death of the settlor passes immediately to the spouse on death – under the original terms of the settlement or by a subsequent appointment made by the trustees – then spouse exemption should be available.

In most cases, this will be irrelevant as on the donor’s death the property remains vested in the donee – often a child. But the point is relevant in relation to settled property where the settlor is a discretionary beneficiary, particularly in relation to trusts that were originally excluded property settlements but have now lost that favoured treatment – either because they hold UK residential property or loans to purchase the same; or because the settlor was a foreign domiciliary within Condition A (born here with a domicile of origin and now UK resident). In these circumstances, the spouse exemption can be highly relevant.

IHTM 14303 now says that: ‘Exemptions that are available on death, such as spouse exemption and charity exemption, may be applicable to the transfer deemed to be made on death if, on death, the property passes to an exempt beneficiary.’

Example 4: Spousal arrangements

Frederick sets up a discretionary settlement holding cash and loans to beneficiaries to purchase UK residential property. Frederick is neither resident nor domiciled in the UK but the relevant loans mean that on Frederick’s death there will be a reservation of benefit (Frederick also being a discretionary beneficiary).

Frederick could be excluded irrevocably as a beneficiary from the trust (at least in relation to the fund comprising the relevant loans). This will be a deemed potentially exempt transfer and he will need to survive seven years. Alternatively, the trustees could appoint that on his death the relevant loans pass outright to his spouse. The appointment could be revocable until Frederick’s death. Of course, this could have other tax implications if the spouse takes the loans outright and is UK resident.

What happens if the trustees of the discretionary trust do not want the surviving spouse to take funds outright? They cannot appoint the spouse an interest in possession, as this will not be a qualifying interest unless the spouse is disabled. A solution may be for the trustees to give the settlor a testamentary general power of appointment and the settlor then exercises that general power in his will, appointing the spouse a qualifying interest in possession which can qualify as an immediate post death interest. The property is then deemed to become comprised in the spouse’s estate.

HMRC does not consider that spousal relief applies where settled property ceases to be subject to a reservation of benefit in the donor’s lifetime. This is because Finance Act 1986 s 102(4) operates by deeming there to be a potentially exempt transfer, rather than by deeming the donor to be beneficially entitled to the gifted property. In the author’s view, this is correct. If the settlor wants to avoid a reservation of benefit problem, he will therefore need to decide whether the trust terms should be changed to give the surviving spouse the property on death or to act now and be excluded from the trust and hope to survive seven years.

In a future issue on reservation of benefits, I will look at how the carve out principle can operate in relation to settled property, a point particularly relevant in relation to insurance schemes.