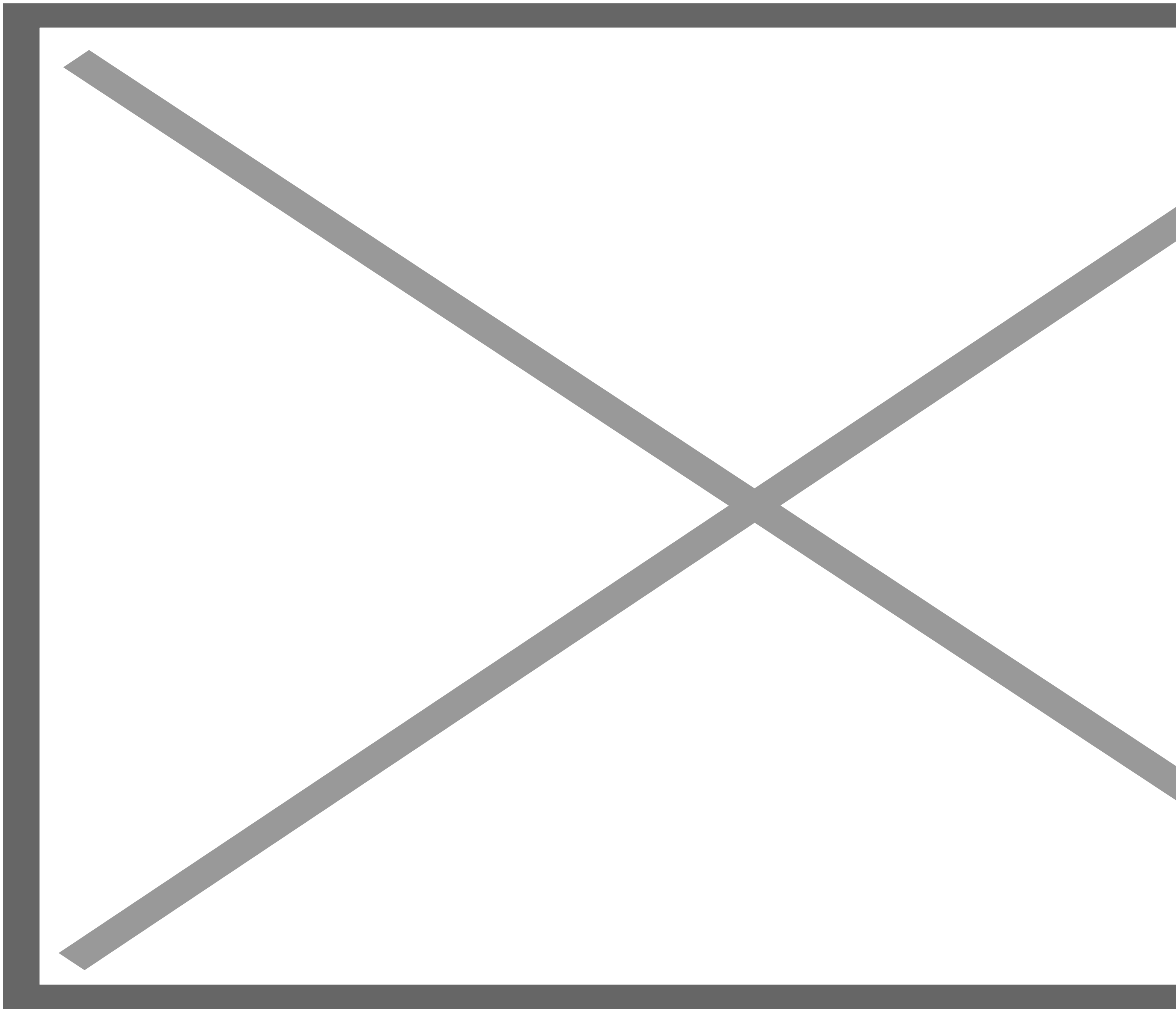
PET spotting

Personal tax



01 April 2016

Keith Gordon discusses the scope of the GWR rules as examined in the *Hood* case

Key Points

What is the issue?

Gifts with reservation of benefit are those lifetime gifts made by an individual which the inheritance tax code treats as being ineffective

What does it mean to me?

There has been a steady trickle of recent cases, most recently, the Court of Appeal allowed the taxpayer's appeal in *Buzzoni v HMRC*

What can I take away?

Given the general similarity of facts between this case and *Buzzoni*, it seems very harsh that the two cases should give rise to such differing outcomes

To me, the initials GWR evoke the image of bygone days in which steam trains would pass through the undulating countryside, combining natural beauty with engineering ingenuity and inspiring confidence for the future. However, the principal relevance of those initials to most modern-day tax advisers is the concept of 'gifts with reservation' in the context of inheritance tax. GWRs, or to use their full name, gifts with reservation of benefit (occasionally also referred to slightly less attractively as GROB), are those lifetime gifts made by an individual which the inheritance tax code treats as being ineffective.

Inheritance tax was introduced by the Finance Act 1986 (FA 1986). For the previous decade or so, the combination of death and taxes was covered by capital transfer tax. The rules were later consolidated as the Capital Transfer Tax Act 1984 (CTTA 1984). However, the 1986 changes led to a number of changes to the CTTA 1984 including the rebranding of the Act itself, renaming it as the Inheritance Act 1984. One of the main changes brought by the FA 1986 was the introduction of potentially exempt transfers (PETs). This meant that certain (most) gifts made by an individual would not be subject to tax unless the transferor were to die within seven years of the date of the gift. Of course, the introduction of this potential exemption meant that statute also needed to deal with cases where beneficial ownership of an asset (typically but not exclusively the family home) was effectively transferred, even though the transferor continued to enjoy use of the asset as before. This led to the revival of the rules dealing with gifts with reservation.

Despite the fact that FA 1986 made a number of direct changes to CTTA 1984, including the insertion of s 3A so as to deal with PETs, the GWR rules were left to remain in FA 1986. Nevertheless, they remain an integral part of the inheritance tax code and should always be borne in mind. Indeed, FA 1986 s 114(5) expressly provides that the GWR code should be construed as if it formed part of the CTTA 1984.

For an example of a straightforward case in which the provisions were completely overlooked, see my article 'The great escape' in *Tax Adviser*, February 2005. A more usual question, however, is whether arrangements undertaken have successfully navigated around or through the rules and so have effectively started the seven-year clock for full exemption.

At the heart of the rules are the following conditions (contained in FA 1986 s 102(1)):

- there is a gift;
- it is made on or after 18 March 1986 (when the new rules were announced); and

- either:
  - possession and enjoyment of the subject matter of the gift is not bona fide assumed by the donee, or
  - the subject matter of the gift 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).

In cases where the rules apply, the subject matter of the gift is treated as remaining within the chargeable estate of the donor (FA 1986 s 102(3)). Thus, transferring ownership of your home to your children, yet continuing to live in it, would not give rise to an inheritance tax saving because the home is treated as remaining in your chargeable estate, notwithstanding the earlier gift. Of course, for capital gains tax purposes, the gift is fully effective and, assuming rising property prices, such an arrangement would also suffer from the loss of capital gains tax rebasing on death (Taxation of Chargeable Gains Act 1992 s 62) and, depending on the family's living arrangements, a potential loss of relief under the only or main residence exemption.

If a gift is caught by the GWR rules, it can be possible to rectify the situation by ensuring that the continued enjoyment of the asset ceases during the donor's lifetime. However, in those cases, the seven-year clock will not start to run until that happens.

A number of cases have considered the impact of these rules, particularly in the context of family homes. Many of these cases go back to the estate duty days or look at equivalent rules applicable in Australia. However, there has been a steady trickle of recent cases arising out of the 1986 incarnation of the rules. Most recently, the Court of Appeal allowed the taxpayer's appeal in *Buzzoni v HMRC* [2014] 1 WLR 3040.

However, the leading case is that of *Lady Ingram* (*Ingram & Another v Inland Revenue* [1999] STC 37) which was decided in late 1998 by the House of Lords. In that case, Lady Ingram had wanted to take her home outside the inheritance tax net, without having to move out. She therefore transferred legal ownership to her solicitor (who held it on a bare trust) and then instructed the solicitor to grant her a 20-year lease (which was designed to exceed her life expectation). The freehold (subject to the lease) would then be transferred to her children. The plan was to leave in Lady Ingram's estate a depreciating asset (the lease), with a corresponding appreciating asset in the hands of her children. Lady Ingram died sooner than expected, a little less than two years after the transactions. However, the increase in property prices in that short period meant that it was still worth determining whether the estate should be treated as including the house at its 1987 value (ie if the gift were effective for IHT purposes) or at the 1989 value (ie on the assumption that it was caught by the GWR rules).

Lord Hoffmann's speech in that case is well worth a read for its clarity. There he explains both the purpose and the limitations of the GWR rules as follows: 'The theme which runs through all the cases is that although the section does not allow a donor to have his cake and eat it, there is nothing to stop him from carefully dividing up the cake, eating part and having the rest'. The House concluded that the rules did not apply in that case, although the result was later blocked by the further changes made in FA 1999.

Facts of the case

The *Hood* case (*Viscount Hood (Executor of Lady Diana Hood) v HMRC* [2016] UKFTT 059 (TC)) concerned a variant of the approach taken by Lady Ingram. Rather than give away the reversion and retain a lease, Lady Hood effectively gave away her interest in her property, but for the gift to come into effect 15 years after the gift was made. The net effect, however, was the same – a depreciating asset in the donor's hands and the appreciating asset in the hands of the intended recipients.

The case was complicated by the fact that Lady Hood's home was held on a long leasehold. The terms of the lease were not unusual and contained the usual provisions preventing part assignment or underletting of the property and, without the landlord's consent (such consent not to be unreasonably withheld) assignment of the whole.

In 1997, Lady Hood asked the landlords whether they would permit the grant of a reversionary sublease in the property. Lady Hood provided the landlords with the terms of the proposed lease. The landlords acceded to the request and a sublease was duly granted in favour of Lady Hood's sons, to come into effect on 25 March 2012. The sublease imposed on Lady Hood's sons the same obligations as fell on Lady Hood herself under the headlease.

Lady Hood died on 15 March 2008 and HMRC issued a determination ruling that the arrangements fell foul of the GWR rules (and were therefore ineffective). The case turned on the meaning of FA 1986 s 102(1)(b) and whether the obligations on Lady Hood's sons constituted a benefit in that they effectively provided Lady Hood with an indemnity in relation to her own obligations under the headlease.

On behalf of Lady Hood's estate, four arguments were put forward to defeat HMRC's case:

1. That HMRC's approach wrongly identified the subject matter of the gift. In particular, it was argued that the gift constituted the bundle of rights and obligations under the sublease. As a result, the sublessees were always subject to the burden of the covenants on them and, therefore, to use Lord Hoffmann's analogy, the benefits retained were never part of the cake given away.
2. Alternatively, any benefit enjoyed by Lady Hood was not at the expense of her sons' enjoyment of the property. Relying on the Court of Appeal's decision in Buzzoni, the benefit fell outside the mischief targeted by FA 1986 s 102(1)(b).
3. Thirdly, it was argued that the benefit of the sublessees' covenants were part of Lady Hood's retained property (and therefore did not form subject of the gift) and therefore FA 1986 s 102(1)(b) was not engaged.
4. Finally, that HMRC's argument would lead to double taxation, suggesting that the case was not within the target of FA 1986 s 102.

The tribunal's decision

The case was heard by Judge Roger Berner. His analysis started with the taxpayer's second argument and focused on the Court of Appeal's decision in *Buzzoni* which was largely informed by Lord Hoffmann's speech in *Ingram*.

Judge Berner noted that, for FA 1986 s 102(1)(b) to apply, there must be some advantage to the donor which was not enjoyed before the gift, but this alone is not enough. In particular, if the benefit to the donor makes no difference to the donee's enjoyment then one has to conclude that the donee's enjoyment was to the exclusion of any benefit to the donor.

However, Judge Berner noted differences between the facts of *Buzzoni* and those before him. In particular, in *Buzzoni*, when permission was sought to grant the sublease, the headlessor committed the potential sublessees to guarantee that they would perform their obligations under the sublease. As a result, the subsequent issue of the sublease put no additional burdens on the sublessees (ie the people in Lady Hood's sons' position). As a result, no benefit was conferred on the sublessor when she granted the sublease. Furthermore, due to the perceived risk of legislation countering the proposals in 1997 (that legislation, in the end, did not come until 1999), Lady Hood's solicitors did not have time to enquire of the headlessor the extent to which they would have granted permission to sublet on terms other than those proposed.

As a result, Judge Berner concluded that, on the facts of the case, Lady Hood's benefit of the covenants impacted upon her sons' enjoyment of their mother's gift.

In respect of the first and third arguments (the subject matter of the gift), Judge Berner noted that this was discussed in Buzzoni albeit as (persuasive) obiter dicta rather than as part of its ratio. Distinguishing the point in *Ingram* (where the House of Lords had emphasised that a landlord's reversionary rights were a distinct asset co-existing with the lease), Moses LJ had concluded in Buzzoni that the rights conferred on by the covenants were properly attributable to the grant of the sublease. Furthermore, these rights were more substantial than those rights enjoyed by Lady Ingram (whose only benefit was the right to quiet enjoyment). Judge Berner adopted the approach taken in *Buzzoni* (and the cases referred to in that decision), concluding that the covenants represent part of the contract inherent in the sublease itself. He distinguished the covenant of quiet enjoyment (as retained by Lady Ingram, for example) as an 'incident' of a lease, rather than a contractual term.

As for the fourth argument, the executors had argued that the valuation rule in s 162(1) (which excludes from relief liabilities if there is a right to reimbursement but that reimbursement cannot reasonably be expected to be obtained) meant that Lady Hood's estate would be treated both as containing the value of the sublessees' covenants and the value of the headlease without any deduction for Lady Hood's covenants under that lease.

Judge Berner held that if double taxation arose, that was simply an effect of FA 1986 s 102. Indeed, Lord Hoffmann had described s 102 as penal in nature. In any event, Judge Berner was of the view that the double taxation complained of probably did not arise. Thus, this argument too was rejected.

Consequently, the executors' appeal was dismissed.

Commentary

Given the perceived threat of new legislation in 1997 (the Labour party had just been elected into office), it is fully understandable why Lady Hood's solicitors acted quickly and it would be unfair to suggest that their conduct should be subject to any form of criticism. However, the end result is that due to the speed of execution, the obligations on the sons under the sublease did not previously exist and this proved fatal to the case. On the other hand, given the general similarity of facts between this case and *Buzzoni*, it seems very harsh that the two cases should give rise to such differing outcomes.

Similarly, there seems to be little from a policy perspective which justifies the outcome in the present case with the likely outcome in a case in which the donor enjoyed the freehold interest of the property and where the question of obligations to the landlord are therefore irrelevant.

It should also be remembered that the *Buzzoni* appeal was lost in the First-tier and Upper Tribunals and that fact might give hope to the taxpayers in the present case. On the other hand, the courts might uphold Judge Berner's decision on the basis of the factual distinction (no matter how slight), meaning that Buzzoni's success represents, for HMRC, a brief encounter with defeat in what they would describe as a tax avoidance case.

Further information

Read Keith's article '[The Great Escape]'.

Read the verdict of the case [here].