

Unnecessary complication

SIMON MCKIE examines the effect of the settled excluded property provision in this year's Finance Bill.

On Budget day, the government announced that the provisions now in Finance Bill 2012, clause 208 would be introduced, explaining:

'The aim of the measure is to close avoidance schemes involving the acquisition of interests in settled property in offshore trusts by ensuring that any reduction in the value of a person's estate as a result of the arrangements is charged to inheritance tax.'

The example, *Suitable settlements*, illustrates how the new provisions apply to their target after discussion with the helpful HMRC spokesman on the matter.

Except where otherwise specified, statutory references are to IHTA 1984.

Before clause 208

Ignoring the effects of clause 208, it appears that the Arrangements shown in the example were intended to have the following inheritance tax consequences.

With regard to the purchase of the call option, in determining whether and to what extent there was a transfer of value, one must value Mr Marigold's estate before and after its purchase (IHTA 1984, s 3). Before the purchase, his estate included the money he was about to pay for the option and the reversionary interest.

Although a reversionary interest is excluded property (s 48), it is only immediately before his death that a person's estate is deemed not to include excluded property (s 5(1)(b)). The market



value of the reversionary interest on its own, however, would have been insubstantial because a purchaser would have taken into account the probability that the trustee would use its power to advance the trust assets to itself.

After the purchase, Mr Marigold's estate included the call option and the reversionary interest. Together they gave Mr Marigold the power to obtain the trust fund which was £1,000,000. The market value of these two assets together would not have been equal to the trust fund because a purchaser would take into account the risk and inconvenience attached to enforcing the contractual and equitable duties of HML. For the sake of illustration we shall value them at £900,000.

So Mr Marigold's estate decreased by £200,000 ((£1,100,000 + nil) – (£900,000)). That was not prevented from being a transfer of value by s 10 because it is clear that it was part of a series of transactions intended to confer a gratuitous benefit on Mr Marigold's issue. Because the transfer was not a gift to an individual and was not attributable to property which became comprised in the estate of an individual, it was immediately chargeable (s 3A). So Mr Marigold made an immediately chargeable transfer of £200,000.

Because the reversionary interest was excluded property, no account was taken of it in determining whether the settlement was a transfer of value (s 3(2)). Therefore Mr Marigold's estate was treated as not having been reduced by the settlement and there was no chargeable transfer (s 3(1)). For the same reason, neither ten-year (s 64) nor exit (s 65) charges arose in respect of the reversionary interest.

The call option gave Mr Marigold the ability to obtain the

KEY POINTS

- Purpose of clause 208.
- Excluded property.
- Practical application of the clause.
- Unnecessary further complication.

principal interest. On its exercise, he held that interest having paid a further £100. Any diminution in his estate, therefore, is likely to have been minimal.

Immediately before his death, Mr Marigold held the principal interest. That was property (s 272) forming part of his estate (s 5) immediately before his death by reference to which inheritance tax was to be calculated (s 4).

Its value was small because any purchaser would take account of the possibility that the trustee would simply accumulate the trust income so that trust income and capital would be paid eventually to the reversionary beneficiary. Nevertheless, it would have some value because of the prospect of negotiating with the reversionary beneficiary to allow the settlement to be brought to an earlier end.

Attractive to clients?

It is true that, were it not for clause 208, the arrangements might offer the ability to take a substantial amount of value out of a UK domiciled taxpayer's estate. This would allow him and his family to benefit from an excluded property settlement but only at the price of:

- making a fairly substantial immediately chargeable transfer;
- bearing substantial costs;
- accepting some commercial risk; and
- accepting the possibility of a long and expensive dispute with HMRC.

SUITABLE SETTLEMENTS

Harry Masters Ltd (HML), a company resident and incorporated in a tax haven which carries on a business of acting as trustee, declared that it held ten sums of £100 each under ten separate settlements. It did so to be able to market a tax planning strategy involving transactions of the type undertaken by Mr Marigold (see below). Under each settlement, the terms on which the trust fund was to be held were as follows.

Principal interest

For a period (the discretionary period) of 150 years the trustee was to hold the trust fund on trust either to accumulate the trust income or to pay it to a named person (the principal beneficiary). The principal beneficiary named in each trust deed was HML itself. The interest of a principal beneficiary at any time was referred to as the 'principal interest'. A principal interest was assignable and did not come to an end on the death of the principal beneficiary with the result that it could pass with the principal beneficiary's estate.

Reversionary interest

At the expiry of the discretionary period, the capital of the fund (including accumulations) was to pass to Kingston Black Ltd (KBL), a subsidiary of HML, absolutely (the reversionary interest). The holder of the reversionary interest at any time was referred to as the 'reversionary beneficiary'. The trustee had the power to substitute any other person as a reversionary beneficiary in place of the existing one. This power could be exercised revocably or irrevocably. Once an exercise of the power became irrevocable the power could not be exercised again.

Mr Marigold enters into the Arrangements

Paignton Marigold was a widower with children and grandchildren who was resident and domiciled in the UK and who had a substantial estate.

Preliminary negotiations

He entered into negotiations with HML and KBL in respect of a tax planning proposal (the Arrangements).

Addition to the Tremlett Settlement

When Mr Marigold had decided in principle that he would proceed with the proposal, but before he entered into a contract, KBL added £999,900 to one of the settlements (the Tremlett Settlement).

Mr Marigold is made the reversionary beneficiary

The trustee then exercised its power to substitute Mr Marigold as the reversionary beneficiary in substitution for KBL. The exercise was revocable at first, but was to become irrevocable after 21 days.

Grant of the call option

Within 21 days of this exercise of the power of substitution by the trustee, Mr Marigold purchased an option (the call option) for £1,099,900 (the grant price). Under the option Mr Marigold could require HML, by notice at any time within 21 years, to assign to him the principal interest for a price of £100 (the exercise price). Under the call option, the trustee warranted that it would pay to Mr Marigold an amount equal to any amount of income or capital advanced to a beneficiary before the option was exercised.

Mr Marigold settles the reversionary interest

Mr Marigold then settled the reversionary interest on broad discretionary trusts for a discretionary class consisting of his issue and any spouses of his issue.

Mr Marigold exercises the option

Mr Marigold subsequently exercised the option when the value of the trust fund was £1,000,000 and paid the grant price of £100 to HML.

Mr Marigold's death

On his death, Mr Marigold left his interest as a beneficial object of the trust under his will to his children in equal shares.

Situs of the trust assets

The assets of the Tremlett Settlement were at all times situated outside the UK.

Although arrangements of this sort have already been implemented by some taxpayers, even if the Arrangements were foolproof, it is doubtful whether there would be many taxpayers wishing to implement them in the future.

Areas of uncertainty

The Arrangements appear to me to present a number of areas of concern.

First, if the trustee's powers are fiduciary in nature, their exercise with the purpose of earning a profit for HML could well constitute a fraud on the power.

Secondly, the fact that the bulk of the trust funds are not added until Mr Marigold is about to enter into the Arrangements and that the assignment of the reversionary interest is clearly designed so that it may be reversed if he does not purchase the call option, suggests that he might be said to be a person who made the settlement indirectly because he provided funds indirectly for the purposes of the settlement. The result would be that he would be a settlor of the settlement (s 44) and the settlement would not be an excluded property settlement at all.

Thirdly, if Mr Marigold had appeared unlikely to purchase the call option, either the substitution of Mr Marigold as the reversionary beneficiary would have been revoked or the trustee would have used its discretion to advance the trust assets to itself. Because of that, it might be argued that the reality of the transaction is that Mr Marigold's payment is in part made in consideration of the trustee refraining from revoking the substitution and for keeping the trust fund intact and thus represents consideration for the reversionary interest. If that is so, the reversionary interest will not be excluded property in Mr Marigold's hands (s 48) and there will be a substantial chargeable transfer when he settles it.

Rather more difficult to evaluate is the fact that the courts are currently extremely hostile to such artificial planning and generally strive very hard to frustrate it.

New provisions

How would the new provisions apply to Mr Marigold's arrangements?

Clause 208 of the Finance Bill amends IHTA 1984, s 48 and also inserts two new sections into that Act: s 74A and s 74B.

The additions to s 48 ensure that certain settled property which would otherwise be excluded property is not to be so. Sections 74A and 74B impose a special charge on an individual (or on the trustees of an interest in possession trust which holds property to which an individual is treated as beneficially entitled under s 49(1)).

Turning first to the amendments to s 48, new sub-section 3D provides:

'Where –

- '(a) one or more persons enter into arrangements,
- '(b) in the course of the arrangements, an individual domiciled in the United Kingdom acquires, or becomes able to acquire (directly or indirectly), an interest in property comprised in a settlement (the relevant settled property),

'(c) ignoring this subsection, the relevant settled property would be excluded property by virtue of subsection (3)(a), and

'(d) there is a relevant reduction in the value of the individual's estate,

'from the time paragraphs (a) to (d) are first satisfied, the relevant settled property is not excluded property by virtue of subsection (3)(a).'

If these conditions are satisfied, the property in the Tremlett Settlement will not be excluded property. The result would be that ten-year charges under s 64 and exit charges under s 65 would apply to the property over the settlement's life as they would do had Mr Marigold made the settlement himself.

Are the conditions of the new sub-section 3D satisfied in respect of Mr Marigold's acquisition? Plainly there are one or more persons who enter into arrangements in the course of which Mr Marigold, who is domiciled in the UK, acquires an interest in property comprised in the settlement. So conditions (a) and (b) are satisfied.

“ The courts are currently extremely hostile to such artificial planning and generally strive very hard to frustrate it. ”

The settled property meets the condition in subsection (3D)(c) because, were it not for the new provisions and subject to the possibility that Mr Marigold is a settlor of the property, it would be excluded property by virtue of s 48(3)(a) as it is non-UK situs property comprised in a settlement settled by a non-domiciled settlor.

The only remaining question, is whether there is a relevant reduction in the value of Mr Marigold's estate. There is a relevant reduction 'if and when the value of the individual's estate becomes less than it would have been in the absence of the arrangements ...'

As we have seen, Mr Marigold's estate is reduced by £200,000 when he purchases the call option. Even if that were not true, the condition is satisfied when he settles the reversionary interest because it is clear that after that settlement the value of Mr Marigold's estate was less than it would have been had he not implemented the Arrangements.

New sub-section (3D) will therefore have the effect that the property within the settlement is fully within the charge to inheritance tax.

New s 74A and s 74B

New s 74A seems designed to impose a charge equivalent to the charge which would have arisen had the individual who actually acquires an interest in settled property settled that property himself. The section applies where by virtue of s 48(3D) property comprised in a settlement ceases to be excluded property. Where it

