The Law of Unintended Consequences

Simon McKie

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When the Finance Bill 2012 was published, it included cl.208 amending IHTA 1984 to nullify some highly specialised Inheritance Tax (IHT) arrangements. The Tax Impact Assessment (the TIA) of the measure explained that "[t]he aim of the measure is to close avoidance schemes involving the acquisition of interests in settled property in offshore trusts …"

The arrangements involved the participant acquiring an interest in a settlement which did not form part of his estate for IHT purposes for full consideration with the result that his taxable estate was reduced.

I analysed the provisions of cl.208 in an article in the *Rudge Revenue Review*[1] and commented:

> "… the planning which is the target of Clause 208 has such disadvantages and uncertainties that it is to be doubted whether it would be used by many taxpayers even if Clause 208 is not enacted. It does not appear a sufficiently serious threat to the Exchequer to justify the introduction of such complex new legislation. …
>
> One might say, however, that apart from some new complexity not much harm is done by the new provision. Whether that is true depends on whether the new provision also catches situations which the Government would not wish to catch."

Clause 208 was subsequently substantially amended: an Explanatory Note, issued at the time, stated that the purpose of the amendments was to extend the range of circumstances to which it applied because the original legislation had failed to close all avoidance opportunities. It also said that the amendments restricted the provisions to arrangements under which consideration is given by one or more of the persons entering into the arrangements so that voluntary arrangements were not caught. The amendments also delayed the commencement date from March 31, 2012 to June 20, 2012 and provided that the provisions as amended were to apply only to arrangements entered into on or after the commencement date and not to existing arrangements. The amended clause was duly enacted as the Finance Act 2012 (FA 2012) s.210.

The amendment to IHTA 1984 by FA 2012 s.210

FA 2012 s.210 inserts into IHTA 1984 three new sections (ss.74A–74C) and amends ss.48 and 201. The effect is that where s.74A applies, settled property which would otherwise be excluded property under s.48(3)(a) because the settlor was not domiciled in the United Kingdom at the time the settlement was made, will not be excluded property.[2] Also, where s.74A applies, tax is charged on a deemed transfer of value[3] which is an immediately chargeable transfer.[4]

[*] Simon McKie MA (Oxon), Barrister, F.C.A., F.T.I.I., T.E.P.: Partner of McKie & Co (Advisory Services), which specialises in providing tax planning advice to private clients and their advisors; tel 01373 830956; email: simon@mckieandco.com.

[1] McKie & Co, "Settled Excluded Property" (2012) *Rudge Revenue Review* Issue XII, 7, 14.

[2] Section 48(3)(a). All references in this article are to the Inheritance Tax Act 1984 as amended by the Finance Act 2012 unless otherwise stated.

[3] Section 74A(8).

[4] Section 74B(1).

Testing the provisions—an example

To what extent do the new provisions ensure that they do not apply to transactions which are not their target? In this article, I test them against the following example.

Monsieur Reinette had always been resident outside the United Kingdom, been domiciled in France and had not had any significant connections with the United Kingdom. In 2000, he settled assets (the Reinette Settlement) on trustees (the Trustees) resident in, and written under the law of, the British Virgin Islands on broad discretionary trusts. In 2005, the Trustees exercised a power to confer on him an interest in possession. The settled property was a 60 per cent holding in the shares of a French investment company (Frenchco). He held the remaining 40 per cent absolutely. In 2008, he married for the second time and his new wife was domiciled and resident in the United Kingdom. They decided to divide their time between France and England with the result that neither changed their country of domicile. On his marriage he made a gift of his shareholding in Frenchco to his wife.

In August 2012, as part of an exercise to balance the interests of his wife and of his children by his previous marriage, the Trustees of the Reinette Settlement (after taking appropriate legal advice) exercised their power to exclude Monsieur Reinette from benefitting under the trust, to create discretionary trusts in the trust fund and to add his wife to the class of beneficiaries. At all relevant times a 100 per cent holding in the company was worth £10 million and a 40 per cent holding was worth £1 million.

The four conditions

Section 74A applies where one or more persons enter into arrangements and four conditions are satisfied.[5]

The first condition

The first condition is that, in the course of the arrangements:

> "an individual ('the individual') domiciled in the United Kingdom acquires or becomes able to acquire (directly or indirectly) an interest in property comprised in a settlement."[6]

For this purpose an individual has:

> "… an interest in property comprised in a settlement if -
> (a) the property, or any derived property, is or will or may become payable to, or applicable for the benefit of -
> (i) the individual;
> (ii) the individual's spouse or civil partner; or
> (iii) a close company in relation to which the individual or the individual's spouse or civil partner is a participator or a company which is a 51% subsidiary of such a close company;
> in any circumstances whatsoever, or
> (b) a person within sub-paragraph (i), (ii) or (iii) of paragraph (a) enjoys a benefit deriving (directly or indirectly) from the property or any derived property."[7]

After the Trustees added her to the beneficial class, Madame Reinette had an interest in property comprised in a settlement; before they did so, she did not. Does that mean that she has acquired such an interest? She must surely have done so. So the first condition is satisfied.

[5] Section 74A(1)–(3).
[6] Section 74A(1)(b)(i).
[7] Section 74C(2).

The second condition

The second condition is that in the course of the arrangements:

> "… consideration in money or money's worth is given by one or more of the persons [who enter into the arrangements] (whether or not in connection with the acquisition of that interest or the individual becoming able to acquire it)."[8]

This condition was inserted by the late amendments to the legislation. It was intended, as we have said, to prevent "voluntary arrangements" from being "inadvertently caught." The condition is deliberately wide, however, so that arrangements which are in essence voluntary but which involve consideration passing in a related but subsidiary transaction will be caught. The giving of consideration need not be in connection with the acquisition of the interest or the UK domiciled individual becoming able to acquire it. It merely has to be in the course of the arrangements.

The second condition is satisfied because the trustees—who are persons who entered into the arrangements by virtue of having exercised their powers to add Madame Michelin to the beneficial class and to defeat Monsieur Reinette's life interest—gave consideration for legal advice on exercising those powers.

We shall consider the fourth condition before considering the third which is the crux of the matter.

The fourth condition

The fourth condition will be satisfied if Condition A or Condition B is met.[9] Condition A is that:

> "(a) the settlor was not domiciled in the United Kingdom at the time the settlement was made, and
>
> (b) the relevant settled property is situated outside the United Kingdom at any time during the course of the arrangements."[10]

Monsieur Reinette was not domiciled in the United Kingdom at the time he made the Settlement and the Trust Property, the Trustees' shareholding in Frenchco, was situated outside the United Kingdom at the time that Madame Reinette was added to the class of beneficiaries. The fourth condition is, therefore, satisfied.

The third condition

The third condition is that there is a relevant reduction in the value of the UK-domiciled individual's estate. There is a relevant reduction in the value of the individual's estate:

> "(a) if and when the value of the individual's estate first becomes less than it would have been in the absence of the arrangements; and
>
> (b) on each subsequent occasion when the value of that estate becomes less than it would have been in the absence of the arrangements and that difference in value is greater than the sum of any previous relevant reductions."[11]

Is there a relevant reduction in the value of Madame Reinette's estate? Clearly there is.

Monsieur Reinette became entitled to his interest in possession before March 22, 2006 and therefore, under s.49, he was treated as beneficially entitled to an interest in the settled property for as long as his

[8] Section 74A(1)(b)(ii).
[9] Section 74A(1)(d).
[10] Section 74A(2).
[11] Section 74C(3).

interest subsisted. Because of that, the shares in the settlement were related property within s.161 in respect of Madame Reinette so that, whilst Monsieur Reinette's interest in possession existed, her 40 per cent holding in Frenchco was valued as a proportionate part of the value of the whole company and thus was valued at £4 million. Once the interest in possession had ceased, the shares in the settlement were no longer related property and therefore her shareholding was valued simply as a 40 per cent holding at £1 million. So the reduction in her estate due to the trust reorganisation was £3 million. She was deemed to make a transfer of value of that amount by virtue of s.74A(8) and that was a chargeable transfer by virtue of s.74B(1). Moreover, the shares in the settlement will not be excluded property for the purposes of future ten-yearly and exit charges. The Trustees' reorganisation of the trust interests has been a disaster resulting in an immediate tax charge of £535,000 (£3 million - £325,000 x 20 per cent) with further charges within the trust to come, and on Madame Reinette's estate if she were to die within five years of the reduction.

Unintended tax charge

So this piece of anti-avoidance legislation which is predicted to have a negligible yield being directed at a piece of tax planning which is unlikely to be attractive to many taxpayers, can certainly apply to arrangements to which it is not intended that it should apply. How significant will be the distortion caused by s.210; only time will tell.

It might be objected that the Trustees in our example should have taken UK tax advice before adding a UK domiciliary to the class of beneficiaries, and therefore, have only themselves to blame for creating a large tax charge. That may be so but it is clear that this situation does not fall within the legislation's target of preventing avoidance stated in the TIA. The addition of Madame Reinette did not confer a taxation advantage, was not entered into in order to do so, and the charge that arose under s.210 did so only by virtue of a quirk of valuation.

Drafting the second major condition in s.74A(1)(b)(ii) in a wide form, in order to satisfy HMRC's determination not to leave a loophole for avoidance however remote, has resulted in the provisions applying to an arrangement which is not the target at which they are aimed.